Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

Study Manual

Taxation, Retail Investment and Pensions

2019/20
Edition

THE PENSIONS MANAGEMENT INSTITUTE (PMI)

Founded in 1976, the Pensions Management Institute (PMI) is the UK's largest and most recognisable professional body for employee benefit and retirement savings professionals, supporting over 6,500 members in 32 countries.

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Published by The Pensions Management Institute, Floor 20,Tower 42, 25 Old Broad Street, London EC2N 1HQ

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Chartered Financial Planner
We are very grateful to Peter for reviewing the text of this edition of the Study Manual.

We are also grateful to the following reviewer of this material:
Tim Middleton FPMI, Technical Consultant, PMI

PMI was formed in 1976 to promote professionalism amongst those working in the field of pensions. Today, we are acknowledged as the institute for pensions professionals. We have developed study and examination facilities leading to a nationally recognised qualification – the Advanced Diploma in Retirement Provision. This embraces all aspects of law and practice relating to the management of workplace pension arrangements. The Advanced Diploma is a comprehensive and in-depth qualification for retirement benefit professionals. It is the qualification component for Associateship (APMI) of the Pensions Management Institute (PMI).

The structure of the Advanced Diploma was comprehensively revised for first examination in 2016. This revision was to ensure that the syllabuses were up to date and the qualification continues to meet the needs of users. The Advanced Diploma framework comprises five core units and seven specialist units. To complete the Advanced Diploma students will need to complete eight units as set out below.

The foundation of the qualification is formed of four core units. These compulsory units cover all aspects of retirement provision in the UK, including regulation, administration, financing and investment. There is an additional option covering international employee benefits. The core units are assessed by a two hour examination. The core units are then followed by specialist units. Students choose either, or both, of the Tier 1 specialist units - Defined Benefit Arrangements or Defined Contribution Arrangements as most appropriate for them. Depending whether both or just one of the Tier 1 specialist units are selected either one or two further specialist units can be selected from the Tier 2 specialist options including Reward, Retail Pensions or International Employee Benefits. These choices allow the students to select those areas that best fit their current work or future career aspirations. Finally the Professionalism and Governance Unit must be completed by all Students. All of the specialist units are assessed by 3 hour written examinations.

There are several Diploma level qualifications comprised of units from within the structure of the Advanced Diploma for those who do not want or need to complete the Advanced Diploma. These have also been revised as part of the changes to the Advanced Diploma.

The Diploma in Retirement Provision (DRP) includes all four UK focused core units and either of the Tier 1 specialist units (Defined Benefit Arrangements or Defined Contribution Arrangements). The DRP would be completed by all those who proceed to complete the Advanced Diploma.

The Diploma in Employee Benefits and Retirement Savings (DEBRS) is ideal for those who need to understand pensions in the wider savings and employee benefits context, and consists of two of the core units and the Tier 2 specialist Reward unit.

The Diploma in Regulated Retirement Advice (DRRA) consists of two Tier 2 specialist units: Taxation, Retail Investment and Pensions; and Retail Advice and Regulation. It is an appropriate qualification for the FCA regulated activity “Advising on Packaged Products” which includes pensions and retirement planning and advising on pensions transfers.

The Diploma in International Employee Benefits (DipIEB) consists of the two internationally focused units: the Foundation in International Employee Benefits core unit and the Tier 2 specialist unit - Managing International Employee Benefits. These units have been developed in partnership between PMI and the International Employee Benefits Association.

Those who wish to complete the Advanced Diploma can opt to take the units that comprise the DRP, DEBRS, DRRA and/or DipIEB on the way to becoming Associate Members of PMI. Alternatively, those who only wish to sit those Diplomas can become Diploma Members of PMI on completion.

There are many benefits to be gained from studying for, and attaining, these qualifications. These include the body of knowledge and understanding gained and its application to practical situations, a demonstrated commitment to learning and development, and enhanced status, confidence and opportunities for career progression.

Undertaking this rigorous professional qualification places demands on students and we are committed to supporting studies with quality learning provision. Under the banner "Shaping the pensions professionals of tomorrow" we are delighted to be working with some of the UK's leading companies and firms within the pensions industry who have taken on the role of study support partners. In each unit the study material comprises a study manual and access to a web-based distance-learning course designed to prepare students for the examinations.

Taxation, Retail Investment and Pensions seek to develop an understanding of the nature of pension arrangements and retail investments together with the fundamentals of the UK tax system.

Further details on the other units that comprise the Advanced Diploma and the work of the PMI can be found on the website. We hope you will enjoy studying for the Advanced Diploma. We welcome feedback and this should be directed to the Qualifications Department at PMI, e-mail: qualifications@pensions-pmi.org.uk

The aim of this unit is to ensure that the student develops an understanding of the UK pension system, the nature of retail investments and the fundamentals of the UK tax system as it applies to individual investors in particular. The study manual is split into four Parts with each Part building on the information contained in the predecessor. An Appendix is also provided, consolidating information on tax, National Insurance contributions and State benefits.

Part 1 looks at the UK pension system. While a financial adviser will of necessity need to look at the individual investments and assets held by his client, the increasing importance of workplace pensions provision means that it is also essential to ask what arrangements his client's employer, and former employers, have made (and that is not limited solely to workplace pensions). The introduction of Automatic Enrolment from October 2012 means that an increasing number of clients will have workplace pension rights which an adviser must take into account. By 2018, there will be few persons in the UK without some level of workplace pensions. This Part considers in detail the background to UK pension provision, types of pension scheme, the legislative background and the ever-changing pension taxation principles which frequently precipitate an adjustment to clients' financial plans to optimise their benefits and assets. Some advisers will also help "employer" clients and therefore it is important to be able to view pensions and other benefits from their point of view as well as that of the individual client.

Part 2 covers the UK tax system in general, looking at tax law and practice and at how to establish the tax liability of an individual. Personal taxation applies to all individuals and includes Income Tax, Capital Gains Tax and Inheritance Tax. In addition, most individuals who are employed or self-employed will be liable to make National Insurance contributions, which, although not strictly a tax, is another source of income for the Government. This Part also looks at indirect taxes such as Stamp Duty and Value Added Tax and we include a section on Corporation Tax.

Part 3 considers the types of investment available, their features and uses. It also considers other factors affecting investment products, such as the economic environment and tax regulations.

Part 4 looks at health and risk benefits. Like pension benefits, which are considered in Part 1, these are some of the most important benefits required by individuals. This Part looks at the State benefits that are available and it also looks inter alia at Permanent Health Insurance, Private Medical Insurance and Critical Illness schemes and considers the tax implications.

On completing your study of this study manual, you will have an understanding of the UK pension system, together with the UK's tax and National Insurance requirements as they apply to the consumer, employee and employer. You will also understand how any State benefits could interact with any financial protection cover they might take out with your advice. You should also have an understanding of how the UK financial services industry operates and the effect that political and economic changes can have on it.

This study manual has been updated for the examinations in October 2018 and April 2019 and will generally be based on the law as it existed at 6 April 2018 though allowance where possible has been made for later (and proposed) legislation.

In this unit, use of masculine words includes the feminine where the context so admits.

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APPENDIX

Aim:
To develop an understanding of the nature of pension arrangements, retail investments together with the fundamentals of the UK tax system.

1. **demonstrate an understanding** the origins and overview of retirement provision
   explain *the following aspects:*
   - *State*
   - *workplace*

   * *individual*

2. **demonstrate an understanding** of the context and the factors which influence the development of retirement provision in the UK
   identify *changes to State pension age, State benefits, historic and forthcoming legislation*
   explain *the options available to access pension saving*
   define *demographics*
   outline *changing social trends*
   describe *balancing work, retirement and income*
   explain *different income needs in retirement and options*

3. **describe** the options available for retirement saving
   outline *the features of:*
   - *tax advantaged savings vehicles*
   - *property*
   - *pension arrangements*

4. **understand** the main features of employee communications with saving for retirement
   outline*:*
   - *statutory disclosure requirements*
   - *the concepts of advice and guidance*

5. **explain** the main features of the employer duties for automatic enrolment and re-enrolment
   describe *automatic enrolment, contractual enrolment and re-enrolment*
   define *jobholders and workers*
   identify*:*
   - *qualifying earnings and pay reference periods*
   - *qualifying schemes and automatic enrolment schemes*

   explain *phasing in and staging*
   describe *the communication requirements and timescales*
   explain *the role of the Pensions Regulator*

6. **distinguish** between the different methods of providing and delivering pensions and the different benefits and options
   identify *the essential features, legal structure, delivery model and characteristics of workplace pension schemes*
   evaluate *occupational pension schemes, personal pensions, stakeholders and SIPPs*
   identify *universal automatic enrolment schemes including master trusts and their roles*
   explain *the roles of the employer, trustees, providers, and employer and provider governance committees*

7. **understand** the context and the main types, and principal features, of workplace pension schemes found in both the private and public sectors, and **explain** the difference between insured and self administered schemes
   define *public sector benefit structure*
   describe*:*
   - *private sector benefit structures*
   - *master trusts*
   - *cross border schemes*

   identify *the features of:*
   - *insured schemes*
   - *self administered schemes*
   - *executive pension arrangements and employer financed retirement benefit schemes*

8. **analyse** a registered pension scheme and the tax treatment conferred by registered scheme status
   outline *the Finance Act 2004 including the tax treatment of:*
   - *contributions*
   - *investment*
   - *benefits (retirement and death)*

9. **understand** the context of the principal features of the current tax regime governing registered pension schemes
   define *Benefit Crystallisation Events and the Lifetime Allowance, including protection*
   outline *the features of the Annual Allowance, including the Tapered Annual Allowance and the Money Purchase Annual Allowance*
   identify *authorised and unauthorised payments*

10. **understand** the tax treatment of unregistered schemes
    define*:*
    - *Employer Funded Retirement Benefit Schemes*
    - *Qualifying Recognised Overseas Pension Schemes*
    - *Excepted Life Schemes*

11. **outline** the various benefit crystallisation events when an individual leaves a workplace pension scheme and **understand** the advantages and disadvantages, administrative requirements including the provision of guidance and risks (including scams) associated with different benefit options
    describe *the options on early leaving, refunds, deferred benefits, transfers (in and out)*
    define *the options before retirement, including redundancy and ill-health*
    identify *the benefits payable on death*
    explain *the options available arising from divorce and the dissolution of civil partnerships*
    describe *the retirement options:*
    - *ill-health retirement*
    - *phased retirement*
    - *flexible retirement*
    - *lump sum options including trivial commutation*
    - *uncrystallised funds pension lump sums*
    - *income drawdown(capped and flexible)*
    - *different types of annuities*

12. **understand** the context of the UK tax system and its impact on individuals and trusts, including liability, collection and computation

describe *the main features of:*

- *Income Tax*
- *National Insurance*
- *Capital Gains Tax*
- *Inheritance Tax*
- *Stamp Duty*
- *Value Added Tax (VAT)*
- *Corporation Tax*

13. **analyse** the nature of the macro economic environment

describe *the main economic trends and explain the globalisation of markets*
explain *the concept of economic and financial cycles and define the key economic indicators*
describe *monetary and fiscal policy*
explain *the balance of payments*
outline *the role of financial investment and the financial services industry*

14. **understand** the context of the principal asset classes

outline *the nature of:*

- *equities (UK and overseas)*
- *bonds (fixed interest and index linked)*
- *cash*
- *property*
- *alternative investments*
- *asset allocation*

15. **understand** the context and the characteristics and taxation of retail financial products

explain *the characteristics and taxation of:*

- *direct and indirect investments*
- *pooled vehicles*
- *derivatives*
- *investment trusts*
- *with profits funds*
- *tax efficient savings vehicles*
- *wraps and other platforms*

16. **evaluate** the needs and priorities for financial protection

analyse *priorities and choices and current and future capital and income requirements*
explain*:*

- *product suitability and other planning considerations*
- *the concept of reviews*

17. **evaluate** the main types and uses of financial protection policies

describe *the role of insurance and the characteristics of:*

- *income protection schemes*
- *life assurance and pension based policies*
- *critical illness cover*
- *personal accident insurance*
- *payment protection insurance*
- *long term care*
- *key person cover*
- *health care schemes*

explain *the concept of regular reviews*

18. **understand** the taxation of financial protection policies

explain *the main features of the taxation of qualifying and non qualifying policies and life funds*

19. **understand** the principal State benefits

describe *the main types of State benefit and the limitations of State benefits*

PART 1 THE UK PENSION SYSTEM

OVERVIEW

In this Part, we provide an overview of and an introduction to the issues surrounding retirement provision.This Part provides a workplace pensions background to the Parts which follow. Workplace pensions have become increasingly important given the relatively new mandatory requirements for Automatic Enrolment of employees into pension schemes and it will rarely make sense for clients not to take full advantage of such benefits. It is essential that the adviser takes all workplace pensions, past and present, fully into account, especially if he also has clients who are employers.

The Part consists of thirteen Chapters.

In Chapter 1 you will learn the historical context of retirement provision. Chapter 2 covers the needs of the employee when saving for retirement, the options available and, finally, the important issue of employee engagement. Chapter 3 outlines Automatic Enrolment, while Chapters 4 to 6 consider the design and structure of workplace pensions. Chapters 7 and 8 look at the important tax background to pensions while the remaining Chapters concentrate on benefits emerging in different circumstances: leaving, transferring, retirement, death and divorce.

When you have completed this Part, you will understand the context and issues surrounding retirement provision and pension saving, the types of benefits emerging from pension schemes and the taxation background to pensions provision within the UK.

INTRODUCTION

In a village or tribal community, the whole community supported those who, for whatever reason, could no longer contribute to the wealth of the group. (It still happens today in less developed economies and even in developed societies since charities as well as families provide a significant measure of support.) This arrangement represented a direct transfer of support from those who could work to those who could not. No reserves would be built up to provide the benefit. Instead, the amount of benefit would be balanced between the willingness and ability of those who could work to provide it, and the needs of the recipients. This is a form of collectivism. The UK Basic State Pension and the safety net of basic welfare support are examples of this.

Instead of relying on the community to provide, people can try to make provision for themselves by saving money during their working lifetimes. This can then be spent in later life. It might have been gold coins in a jar, or even money under the mattress, but it was a basic form of funding. This is a form of individualism. Its effectiveness depends on the amount of money saved and what this will buy when the person's working life is finished. Most individuals in the UK make some provision for their retirement to top up community support.

The origins of present-day pension arrangements can be found in the emerging collectivism of medieval times. If an individual fell on hard times through illness, disability or old age, the only help was from the Church, the ruling Lord's Manor or the local boroughs. As Guilds developed, they also played an important part in helping individuals in need. Guilds were religious or charitable organisations, which developed into the trade associations of merchants and craftsmen that still exist today. These charities were usually only able to help in the event of sickness, disability and in the provision of pensions for widows and orphans.

The State became more involved in the Elizabethan era, when the welfare of the poor became a national concern. The power of the Tudor monarchs was replacing feudal society while Henry VIII had acquired significant monastic wealth through the Dissolution of the Monasteries in the 1530s. Traditional feudal and monastic support for the poor was being removed and the problem was compounded by now-homeless monks and nuns swelling the ranks of the needy. The problem of the "sturdy beggar", while not new, was escalating and further Poor Laws were passed particularly during the reign of Elizabeth being codified by 1601. The codified legislation made the local parishes responsible for providing for the poor within their areas.

During the Victorian era, the 1834 Poor Law introduced workhouses designed to discourage persons from relying on others for their upkeep. The widely accepted ethos, at least by those who had the vote and who generally had to pay the poor rate, was for self-help. Enfranchised society did not feel that the State needed to provide pensions for the general population. Neither was it expected of the employers of the time, although some did provide pensions for their workers. So, generally, it was left to the workers to group together and provide for themselves in times of financial hardship. This led to the emergence of self-help groups some of which later became the first friendly societies. However, short life expectancy and the extended family meant that the main benefits the societies paid out were death benefits, sickness and disability pensions, rather than pensions after retirement.

Against this changing socio-economic background, successive Governments gradually began to address the new developments and emerging needs by introducing further legislation. Employers also became increasingly involved in private pension provision.

1.1 THE MAIN FINANCE ACTS

1.1.1 The Foundations: Finance Acts 1916 and 1921

The principal piece of early legislation governing insured schemes is the 1916 Finance Act which granted tax relief on premiums in connection with all 'bona fide pension schemes'.

The 1921 Finance Act formed the basis for the legislative structure that has governed occupational pension schemes for most of the last 100 years. It established the principle upon which pensions tax relief still generally operates: this is the EET principle:

- contributions are **E**xempt from tax
- investments built up are largely **E**xempt from tax
- pensions are payable subject to **T**ax

To be eligible for this tax treatment, the scheme had to be established under trust; and its sole purpose had to be the provision of annuities for former employees during their retirement.

The requirement to provide annuities, later extended to other forms of regular income, reflected a concern that had been expressed many years earlier by the Radley Commission on the Civil Service. The Radley Commission, which sat in 1888, objected to the payment of a lump sum on the ground that "in the event of improvidence or misfortune in the use of it, [the retired member] may be reduced to circumstances which might lead to him being an applicant for public or private charity." (It will be interesting to see how the recently introduced freedoms to encash pensions reawaken the fears expressed by the Radley Commission.)

1.1.2 The 'New Code': Finance Act 1970

Subsequent legislation introduced further changes, including limits on contributions and on the amount of pension that could be commuted for a lump sum; and introduced retirement annuities, principally for the self-employed.

By the late 1960s, with over half the workforce being members of occupational pensions, the pension system was in need of rationalisation and consolidation. The result was the Finance Act 1970 (FA70) (and the Income and Corporation Taxes Act 1970, a consolidating Act which preceded FA70 by just ten weeks) which introduced the 'New Code' under which occupational schemes needed to be approved by the Inland Revenue (forerunner to HMRC). Retirement annuities for the self-employed continued, under the provisions of s226 Income and Corporation Taxes Act 1970, the Finance Act 1956 having earlier introduced tax reliefs for pensions for the self-employed.

New Code approval allowed a maximum pension of up to 2/3rds of final pay at Normal Retirement Date, part of which could be commuted for a lump sum of up to 1.5 times final pay, normally using a commutation factor of 9:1 for males aged 65. This equated to commuting a maximum of 25% of the pension for cash. Other commutation factors could be used for females (11:1 at 60, for example), at other retirement ages for males or if the pension increased in payment.

There was no limit to the amount of benefit that could be accumulated on a tax-exempt basis within a retirement annuity ('s226 contract'), which was constituted on a money purchase, or defined contribution (as it is now known), basis. However contributions were limited. This limit was expressed as a percentage of remuneration that depended on the individual's age. Part of the benefit could be taken in the form of a lump sum (generally three times the maximum available pension).

1.1.3 Simplification: Finance Act 2004

In December 2002, two Green Papers – consultation documents – were published by the Inland Revenue and the Department of Work and Pensions and these set out the Government's intention to consolidate and radically simplify the tax legislation relating to pensions in order to reduce administrative costs and to allow more flexibility in scheme design. A principal intention was to remove the then eight separate pensions tax regimes and replace them with a single regime. (Few practitioners at the time of introduction in 2006 believed that "simplification" had worked and pensions technicians found that their role became even more vital as layer after layer of regulations and new legislation ensued.)

The Green Papers led to the Finance Act 2004 (FA04) which set out the legislative basis for the current pensions tax regime, introduced with effect from 6 April 2006. Under this regime, which replaced the previous 'discretionary approval' by the Inland Revenue (and the less-well known automatic approval allowed by s19 of FA70), employers and members are able to benefit from the tax advantages associated with pension schemes provided the scheme is 'registered' with HMRC, and makes payments that are 'authorised'.

Despite all the changes to the tax legislation governing pension schemes, the underlying principles reflected in the 2004 Act were broadly unchanged from the EET principles underpinning the 1916 and 1921 Acts: subject to certain limits, tax relief would be available on contributions made to bona fide pension schemes, being pension schemes set up with the main purpose of providing an income in retirement, which income would then be taxed. Apart from changes of detail, arguably the one change of principle introduced by the Act was a wider recognition of an emerging need for 'flexible retirement' towards the end of the working life, in allowing pension to be drawn while continuing to work, perhaps on a part-time basis – thus taking an income from the scheme before technically being 'in retirement'.

1.1.4 Pensions Freedom: Finance Acts of 2011 and 2015

Under FA04 (as modified by FA05), one of the ways in which schemes were able to provide an income in retirement was through capped 'Income Drawdown'. This allowed the member to take varying amounts each year (in contrast to the regular instalments received with a pension or annuity). However under 'Capped Drawdown', the maximum amount of income that could be taken in any year was limited by regulations designed to ensure that the member did not run down funds too quickly.

The Finance Act 2011 introduced further freedom in the choices available to certain members through the concept of 'Flexible Drawdown'. This allowed an individual who was no longer an active member of any scheme and who satisfied the 'Minimum Income Requirement' (MIR) to take uncapped 'Flexible Drawdown'. This meant that there was no limit to the drawdown amount that they could take in any year, which was taxed as pension income in the normal way.

A core idea behind the MIR was that there should be no risk of someone, who depleted their fund quickly, falling back on State benefits. To qualify for "Flexible Drawdown", the person needed to have a secure pension income above the threshold amount of the MIR. The MIR included State pensions, scheme pensions and lifetime annuities, as well as some other State benefits and overseas pensions. Income drawdown itself was specifically excluded, as too were (oddly) purchased life annuities. Initially the MIR was set at £20,000 p.a.

For some individuals, therefore, Finance Act 2011 changed a fundamental principle that had underpinned tax-privileged pension provision for a century – that pension funds should be used to provide an income for life (with the exception of the limited amount allowable as a tax-free lump sum). Arguably this change was not that radical, because it affected only the small minority of members who were able to satisfy the MIR. But the principle was established and undeniably-radical change did follow.

In the March 2014 Budget, the Chancellor George Osborne announced that from 6 April 2015 people aged 55 and over would be able to make withdrawals from their defined contribution (DC) pension pot "how they want, subject to their marginal rate of income tax in that year." This new 'pensions freedom' was to be available to all pension scheme members aged 55 or over, irrespective of income from other sources. Members with defined benefit (DB) pension entitlements however or with money purchase pots in an arrangement that had decided not to offer the new options would need to transfer to a different arrangement in order to take advantage of the new flexibilities: this latter aspect giving rise to complex planning and advice issues, where the adviser needs to take particular care.

The new freedoms did, however, raise a number of problems, including:-

- Will members, particularly those without significant wealth, have access to suitable advice regarding their options (the so-called 'advice gap')?
- Will they become targets for investment 'scams'?
- Will they make sensible investment choices well before retirement in the so called 'accumulation phase'? And for the majority who do make active choices in this area, is it possible to design an appropriate default fund for a member without knowing when or in what form he might decide to take his benefits?
- Are there unacceptable barriers in the way of members who need to transfer in order to take advantage of the new flexibilities, due to excessive costs or delays in the process?

Nevertheless, the new measures were implemented very quickly – the announcement was made in March 2014 (without a prior consultation period) and the necessary changes to the tax legislation were contained in the Taxation of Pensions Act 2014, effective from 6 April 2015. This timescale can be compared with the 10 year transition period accompanying the introduction of the New Code, and with the introduction of the 2006 'Tax Simplification' measures which had a lead-in period of some four years.

One reason for this accelerated implementation was the fear that the longer the delay between the announcement of forthcoming flexibilities and their actual availability, the greater would be the increase in pent-up demand: members putting off accessing their pension until the new flexibilities were available. The concern was that as the pent-up demand grew, it would result in a major capacity crunch, with a flood of members all wanting to take their benefits at the same time.

Another reason was perhaps the Chancellor's hope to gain more money for the Treasury: from April 2015 up to October 2017, at least £14.2bn has been accessed subject to the individual's marginal rate of tax (Source: HMRC Bulletin: Flexible Payments from Pensions: Released October 2017).

The combination of the radical nature of the change and its very short lead in period has required an period of intense activity by Government departments and regulators, the pensions industry and those managing or sponsoring pension schemes in order to ensure that the new measures are implemented as intended and without consumer detriment..

1.2 STATE PENSION BENEFITS

In the UK many current pensioners rely almost wholly on the State for the benefits they receive in retirement. This is expected to change in the future as employee membership of occupational and personal pension schemes following the introduction of Automatic Enrolment. However it is expected to take many years before most those being enrolled in to a pension scheme for the first time will have built up sufficient funds to generate a significant income in retirement.

For those who reached State Pension Age (SPA) before April 2016, there are two State schemes in operation: the Basic State Pension (BSP), sometimes called the old age pension, and the State Second Pension (S2P). S2P replaced the State Earnings Related Pension Scheme (SERPS) with effect from April 2002. Persons, including clients now in receipt of pensions benefits, working during the period from 1961 to 1975 may also have a small State Graduated Pension addition.

For those reaching SPA from April 2016, State retirement provision is from one flat-rate, single-tier State Pension, referred to here as the 'New State Pension'.

In countries where the level of State benefit is high, such as France and Italy, in many cases the benefits comprise a high proportion of an individual's income in retirement. In other countries, such as Australia, New Zealand, Belgium, the Netherlands, the UK and the US, significant retirement provision is often made privately with the relative contribution from the State often being much smaller.

Most State pension arrangements, including the UK's, are funded on a 'pay as you go' basis. This means that assets do not build up during a working lifetime, but the contributions of today's workers are immediately used to pay the benefits to today's pensioners.

This can be viewed as a contract between generations. However, problems can arise if a population 'ages', due to factors such as increasing longevity. In this case, unless there is an increase in the birth rate or in net immigration (on the basis that immigrants are on average younger than the population as a whole), the number of contributors compared with recipients declines as is currently the case in the UK. If this is not to result in an increasing burden on the younger generation, the level of state pension has to either reduce or be paid for a shorter period (by delaying the start date).

State benefits may take the form of a universal flat rate benefit, or an earnings related benefit or, as has historically been the case in the UK, a combination of the two (although this combination has been replaced by a single tier system for those reaching SPA from 2016).

In the UK, pensioners on low incomes and with modest savings have also been able to receive extra payments from the State through a means tested benefit (called the Pension Credit, formerly the Minimum Income Guarantee), which brings their total benefit up to a prescribed level. However the New State Pension has been set at a level that will mean that eligibility for Pension Credit will decline and it is expected to eventually become unnecessary.

1.3 RETIREMENT PROVISION FROM NON-STATE PENSIONS

The National Employment Savings Trust (NEST) published results from research it carried out in 2014 stating that 76% of the population has some form of pension savings and this is expected to increase further as Automatic Enrolment covers more employers and employees. This was borne out by the Pensions Regulator's corporate plan 2017-2020 which observed that the membership profile of pension schemes has undergone huge expansion since the start of Automatic Enrolment in 2012, with the vast majority of the 7.3m new members joining DC workplace pension schemes. The Regulator noted, however, that coverage was only around 40% of the working population as worker groups such as the self-employed and multiple job-holders are generally not, as yet, participants in Automatic Enrolment.. (We look separately at the role of NEST and at Automatic Enrolment later in this Chapter.)

Valuable tax reliefs are offered to employees and the self-employed to encourage them to make provision for themselves through group or individual schemes. Employees who choose not to join, or are not eligible for an employer sponsored arrangement, as well as the self-employed, can have an individual arrangement instead. Within certain limits, employees may have both an employer sponsored and an individual arrangement and gain tax-reliefs on both.

1.3.1 Employer Sponsored Benefits

Employer sponsored schemes are established either as a trust, by an Act of Parliament or on a contract basis. In the past, most members of such schemes could expect to receive pay-related benefits, called final salary benefits or defined benefits, where the benefit is expressed as a proportion of pay close to retirement (or date of leaving if earlier) for each year of service. However an increasing number of members will receive benefits on a money purchase or DC basis where the benefit is the product of the contributions paid in, the investment returns achieved while those contributions are invested. To the extent that the benefit is provided in the form of an annuity, the amount will depend on annuity rates at the time of purchase.

1.3.2 Public Sector Pension Schemes

Public sector schemes are divided between statutory schemes and non-statutory schemes. Statutory schemes have their provisions contained in either a statute, a statutory order or an instrument made under a statute. The non-statutory schemes are mainly those of the nationalised industries and are usually established by a Trust Deed and Rules in a similar way to employer sponsored private sector schemes. A relatively small number of public sector schemes cover millions of employees whereas in the private sector smaller groups of employees are covered by thousands of schemes. The public sector includes public corporations such as the Bank of England and the Civil Aviation Authority.

1.3.3 Personal/Individual Benefits

Most individual plans are on a money purchase/DC basis.

Individuals who belong to an employer`s scheme can also pay additional voluntary contributions (AVCs) or take out other pension arrangements or a personal freestanding additional voluntary contribution arrangement (FSAVC). FSAVCs are insured arrangements that are usually unconnected with any particular pension scheme and which individuals can use to increase their retirement provision, subject to limits on the total contributions payable. They came into existence at a time when there were restrictions on members of Occupational Schemes being concurrently contributing members of Personal Pensions. These restrictions no longer apply and many FSAVC contracts have since been converted into Personal Pensions.

1.3.4 Stakeholder Pensions

Stakeholder arrangements provide benefits on a DC basis. They have to meet certain requirements to make them more accessible, including more flexible contract terms and charges capped at a level that was lower that than often provided in the past by personal pensions.

Between October 2001 and October 2012 every employer with five or more employees had to provide access to such a scheme unless they offered an employer sponsored arrangement which all qualifying employees could choose to join. However, there has never been any requirement for the employer to contribute to it, nor for employees to join it. As a result the Stakeholder regime did not encourage pension saving to the degree that successive Governments have considered desirable and has been overtaken by the Automatic Enrolment regime introduced by Pensions Act 2008 and which started coming into effect from 1 October 2012.

The requirement to 'designate' a Stakeholder pension scheme ceased to apply with effect from 1 October 2012, though advisers will come across clients with Stakeholder pension scheme rights.

1.4 THE CURRENT PENSION SCENE

1.4.1 The Pensions Act 2007

In July 2007 the Pensions Act legislated for the reforms to the State pension system announced in May 2006. The Act also created the Personal Accounts Delivery Authority to advise on the introduction of a new, simple, low cost pensions savings vehicle, originally named 'Personal Accounts' but subsequently renamed 'NEST'. The purpose was to extend the benefits of workplace schemes to those currently without access to them by establishing a simple, low cost pension scheme available for all employers whether or not they have suitable alternative pension arrangements.

1.4.2 The Pensions Act 2008

In November 2008 the Pensions Act 2008 introduced measures aimed at encouraging greater private saving. This included a duty on employers to automatically enrol all eligible workers into a qualifying workplace pension scheme (provided they are not already in such a scheme). Most of the measures in the Act came into effect from 2012.The Act broadened the remit of the Personal Accounts Delivery Authority giving it powers to enable it to establish NEST.

1.5 PERSONAL SAVINGS

This source of retirement provision can take many forms. The most common of these are savings accounts, insurance policies. Individual Savings Accounts (ISAs) (which in 1999/2000 replaced Personal Equity Plans and TESSAs (Tax Exempt Special Savings Arrangements)), unit trusts and investment trusts and the proceeds of the sale of houses or businesses.These are covered in more detail in Part 2 of this study manual.

Summary

We began this Chapter with an outline of the origins and development of retirement provision and pensions through the nineteenth and twentieth centuries. As well as occupational pension schemes this included an overview of State pensions and public sector pensions. Finally, it included a summary of the current retirement provision options and the most recent developments known as Pensions Flexibility (sometimes known as Pensions Freedom).

Self Test Questions

- What is the EET Principle?
- What changes were introduced with the Finance Act 1970
- What is Drawdown?
- How are State pensions funded?

INTRODUCTION

How individuals can be supported financially after they can no longer work, has always been an issue. Solutions tend to be found in a number of ways including: using up savings, depending on the family, drawing a private pension or relying on the community and/or the State. The balance between these solutions differs between individuals and it also changes over time, driven by political, social and economic factors.

The Pensions Policy Institute (PPI) (an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision) has researched whether individuals have sufficient income to meet their needs at retirement. In one of its reports it is interesting to note that the majority of people feel that in order to be satisfied with their level of income at retirement, they would want a standard of living broadly similar to that they enjoyed during their working life. The PPI believes that this equates to an income of between 50% and 80% (gross) of their working life income, with the higher percentages appropriate to those with lower earnings (and for whom a higher percentage of income is spent on necessities, the need for which continues in retirement).

21 THE NEEDS OF THE EMPLOYEE WHEN SAVING FOR RETIREMENT

2.1.1 Obstacles to Saving

Around the turn of the millennium there was a growing concern that people were not saving enough for their retirement, the problems being particularly acute for lower paid workers. There are a number of important factors which have contributed to successive generations not making sufficient savings.

Voluntary savings have been affected, to varying and contrary degrees, by the following:

- The rise in the welfare state, which largely removed the threat of absolute poverty.
- Affordability – cost of living has an impact. The need for food, clothes, rent/mortgage, transport, loan repayments, bills and child-related costs all decrease the amount of disposable income that can be used for savings/pensions.
- Behaviour – individuals tend to prioritise their immediate needs before thinking longer term e.g. an annual holiday or a new car can often be an attractive reason to use disposable income/savings.
- Culture – Arguably a persistence of the 'spend now, pay later' culture which developed in the credit boom years of the 1980s, contrasting with the savings culture of past generations.

To make matters worse, at the same time as these factors were working to depress pension saving, it was becoming increasingly clear that economic and demographic factors were far less favourable than twentieth century politicians has been prepared to accept:

1. Longevity was forecast to rise significantly, resulting in longer expected periods of retirement that would somehow need to be financed (and how was this to be done given the expected fall in the ratio of workers to retired people); and
2. It appeared that long term investment returns were unlikely to be as high as had been believed previously.

As a result of these concerns, in 2002 the Government set up The Pensions Commission, under the Chairmanship of Adair Turner, which in 2004/5 reported its findings. These included that most people do not make rational decisions about long-term savings without encouragement and advice. But the cost of advice in itself significantly reduces the return on saving, particularly for low earners. The Commission went on to report that the behavioural barriers to savings and the costs of provision have been made worse by the "bewildering complexity of the UK pension system, state and private combined", which has caused confusion and mistrust. Furthermore, it found that means-testing within the State system both increased complexity and reduced the incentives to save via pensions.

2.1.2 High Level Solutions

It is clear that individuals can often face difficult decisions when it comes to saving for retirement – should they spend now or save for a rainy day? The cost of living in retirement continues to rise and the need to save becomes even more important because of it. So, what are the solutions? This is a key question for Governments. There are various views on what the optimal solution may be, but we set out below some of the potential solutions.

- Moving away from unfunded State provision and favouring a privately funded alternative. This is one of the more controversial suggestions.
- Encouraging people to save more.
- Encouraging more people to save. The thought process is simple: if it is possible to encourage/enable people who are currently not saving to save a little, this would reduce reliance on the State and would also help enhance people's standard of living. The Government is actively trying to encourage more people to save by the introduction of Automatic Enrolment (which is covered in depth elsewhere in this study manual).
- Late retirement. Many schemes already allow members to retire after they reach their Normal Retirement Date. The default retirement age of 65 (i.e. an employee's contracted retirement age) was abolished from 1 October 2011.This means that employers are not able to retire employees simply because they have reached their 65th birthday. Employees can choose to retire from age 65 if they wish but it is no longer compulsory, unless an employer can justify such a decision. Such justification might be, for example, on the grounds of the capability of a particular employee. Alternatively, the Courts have found in favour of companies retaining a compulsory retirement age in circumstances where doing so was judged to be a proportionate means of achieving legitimate aims. With the increase in the SPA (see 2.2.3), it is expected that more people will work beyond their Normal Retirement Date (which is not impacted by the removal of the default retirement age). Some may choose to defer retirement even later and call upon the Scheme's late retirement provisions, whereby an individual can increase their State pension by starting it later.
- Partial retirement. Partial retirement enables a pension scheme member to reduce the number of hours they work by drawing on their pension while remaining in employment. This enables an individual to continue to earn a salary for a longer period, while getting used to the idea of retirement by gradually reducing their hours.

An adviser needs to make his client aware of all the above "solutions", both initially and at reviews when circumstances may have changed. The route forward may be one of or a combination of the above.

22 RECENT DEVELOPMENTS IN STATE PENSION PROVISION

Unlike occupational pensions and personal pensions, State pensions are not pre-funded. Instead they are financed on a 'pay as you go' basis. Broadly speaking this means that the amount needed to pay pensioners in any year is taken from the tax and National Insurance Contributions (NICs) paid in that year.

This means that the system is very susceptible to demographic changes, in particular the 'age dependency ratio' (the ratio of individuals who are retired to those who are economically active). Factors such as increasing longevity and falling birth rates have put unfunded State pension provision in the UK and in Western Europe generally, under increasing strain.

On 25 May 2006, the Government published its White Paper 'Security in retirement: towards a new pensions system'. This paper was published in response to the Turner Report. The White Paper announced the Government's intention to reform dramatically the way in which State retirement benefits are provided.These proposals were confirmed in the Pensions Act 2007. As well as paving the way for Automatic Enrolment (see later), the 2007 Act included the following changes in relation to State pensions:
(Note that although the New State Pension has now replaced the BSP and State Second Pension for those reaching SPA from April 2016, the previous types of State pension are still relevant since they will continue to be paid to those who reached SPA before April 2016.)

2.2.1 Basic State Pension (BSP) Increases

From April 2011 Government policy is that annual increases to the BSP will be made in line with the 'triple lock', being the greater of National Average Earnings increases, price inflation and 2.5% p.a. This 'triple lock' is not, however, written into legislation and has been the subject of some political debate. It is therefore possible that, as a result of future constraints on social security spending, the rate of increase will fall back to a lower level.

2.2.2 State Second Pension (S2P)

The 2007 Act provides for the accrual rate of S2P to reduce in two stages, the intention being that it would be converted over time to a flat-rate top-up to the BSP, the change being expected to be completed by around 2030. In the event, however, it was subsequently decided to replace S2P altogether – see 2.2.4).

2.2.3 State Pension Age (SPA)

The Pensions Act 1995 had set out a timetable for increasing the female SPA from 60 to 65 over the period 2010 to 2020 to bring it into line with the male SPA.The Pensions Act 2007 amended this timetable, providing for SPA to gradually rise to 68 by 2046 with intermediate dates for those between 65 and 68. However, the timetable for SPA increases was again subsequently modified and is currently as follows (for both men and women):

- from 65 to 66 between 2018 and 2020 (amendment introduced by Pensions Act 2011);
- from 66 to 67 between 2026 and 2028 (amendment introduced by Pensions Act 2014);
- from 67 to 68 between 2044 and 2046 (as Pensions Act 2007).

The Pensions Act 2014 also provides for periodic reviews of future increases to take place at least once every five years. The review will seek to give individuals affected by changes to their SPA at least ten years' notice. The review will be based around the idea that people should spend a certain proportion (intended to be a third) of their adult life after age 20 drawing the State Pension. Using current mortality projections, this would suggest the increase in SPA from 67 to 68, instead of occurring between 2044 and 2046 as provided for in the 2007 Act, is likely to be brought forward to the mid-2030s (and then increase to 69 by the late 2040s). Indeed, following an independent review led by John Cridland and published in July 2017, the Government announced proposals to bring forward the deferment of SPA from 67 to 68 by seven years to 2037~39. Interestingly, the Old-Age Pensions Act of 1908, in introducing the first State pension, provided a weekly pension for persons over age 70 (subject to certain conditions).

There has been some concern regarding the effectiveness of the communication of the increases in SPA.This is considered to have particularly affected women, many of whom were unaware of the equalisation of the SPA legislated for in 1995. A report by the Work and Pensions Committee published in March 2016 concluded that successive Governments' attempts to communicate the SPA changes have been 'too little too late for many women'. The cohort of women born in the 1950s was felt to be particularly affected, with some (born before March 1950) retaining a SPA of 60 while others (born after August 1954) seeing their SPA pushed back to age 66 and not being able to draw their State pension until 2020 at the earliest. However, cognisant of the financial constraints, the Committee stopped short of recommending a change to the timetable, instead suggesting that those particularly affected should be permitted to retire earlier on a reduced State Pension (calculated on an actuarially reduced basis). Shortage of Parliamentary time means that changes are now unlikely to occur and the age 66 SPA is likely to apply for both men and women in 2020.

2.2.4 The New State Pension

In 2011, the Government issued a Green Paper which included the proposal for a universal flat rate pension set above the threshold for most means tested benefits. Following consultation, legislation was included in the Pensions Act 2014.

The New State Pension applies to those who reach SPA on or after 6 April 2016. The level of the New State Pension is set by Regulations each year. In 2019/20 it is £168.60 per week (just above the level of the single person Guarantee Credit of £167.25). The legislation provides that it will be increased in line with earnings, although the current intention is that the 'triple lock' currently applying to the BSP (see 2.2.1) also applies to the New State Pension.

While the New State Pension is often described as being 'flat rate' it is important to understand that not everyone will receive the same amount, first because not everyone will have sufficient qualifying years to be eligible for the full amount and secondly because there are transitional arrangements whereby previous expectations in relation to the BSP and S2P are 'grandfathered in', in some cases resulting in a pension that is greater than the standard 'flat rate'.

The New State Pension will be paid at the full rate to individuals reaching SPA on or after 6 April 2016 with 35 or more 'qualifying years'. As for the BSP it replaces, qualifying years are those in which National Insurance Contributions have been paid or credited.The rate paid will be 1/35th of the full rate for each qualifying year for those whose qualifying years are in number less than 35 but more than 10). Those who are not entitled to the full rate will be able to increase their entitlement by paying voluntary (Class 3) National Insurance Contributions in order to fill any "gaps" in their NI record during the previous six years.

There is an option to defer receiving the New State Pension past SPA, or to suspend its payment, in which case an increased amount will be payable (unless the individual was receiving certain State benefits during the period of deferral or suspension). The increase is 1/9% for each week of postponement or suspension (1/5% a week for those who reached State Pension Age before April 2016).

Under transitional arrangements, those who have built up an entitlement to the BSP and/or S2P at 6 April 2016 will have this entitlement compared to the New State Pension that they will have accrued at that point under the new rules. The higher amount will then be reduced to take account of any period of contracted-out employment and will then form the 'foundation amount'. If the foundation amount is lower than the full rate of New State Pension, the individual can use further qualifying years to build up their entitlement to the full rate. If the foundation amount is more than the full rate, the individual's rights will be 'protected' in that they will retain an entitlement to this higher amount. Over time, however, the protected foundation amount will only increase in line with prices.This compares with the New State Pension rate which will increase at least in line with earnings and, for so long as the triple lock continues, at the greatest of: prices, earnings and 2.5% p.a.. Historically, the long-term trend has been for earnings to increase faster than prices (although over the shorter term, this relationship has not always held).

2.3 PERSONAL SAVINGS AND OPTIONS FOR RETIREMENT SAVING

Pensions are just one form of providing an income for individuals at retirement.

There are many other saving vehicles which individuals can take advantage of to help boost their retirement income. We consider these wider savings options further in Part 3 of this study manual. At this juncture we will continue to concentrate on workplace related benefits.

2.3.1 Corporate Wraps

The concept of introducing a 'corporate wrap' (also known as 'workplace savings' or 'corporate platforms') has attracted some interest. A typical arrangement might allow employees to contribute through their payroll into a choice of ISAs, pensions and investment accounts. It allows the employee to manage workplace and personal financial benefits in one place. Its aims are quite simple:

- To encourage employees to take an active interest in their medium and long term financial affairs;
- To enable employees to become more financially educated; and
- To encourage better outcomes at retirement.

Some of the financial advantages of this vehicle include:

- Employees can maximise their tax breaks by investing in a number of savings options.
- Flexibility – DC employer pension contributions can be invested in an ISA, which is beneficial for an employee wanting to save for a deposit or a high earner affected by pension tax restrictions.
- Money can be transferred e.g. maturing shares can be rolled into an ISA.

However, the vehicle is complex to create and it is extremely important that the level of financial education is right, the communication is concise and clear, and that employees have sufficient tools to enable them to make appropriate decisions.

2.4 ENGAGING EMPLOYEES WITH SAVING FOR RETIREMENT

Being able to save for retirement, either through a pension scheme or equivalent vehicle, is an important part of an employee's benefits package, which has the potential to be highly valued by an individual. It is therefore important to ensure effective member communication as an aid to ensuring an employee's engagement. Recognition of this communication aspect is important for advisers dealing with workplace benefits.

2.4.1 Effective Communication

The art of creating an effective piece of communication is all about getting the right message, to the right person, at the right time. The Pensions Regulator (TPR) has released guidance on producing effective member communications to help pension schemes to support members and help them get the best out of their pension provision.

It is widely agreed that members who have a lack of understanding of their pension arrangements may make ill-informed decisions or take no action at all. This is particularly significant for members of DC schemes where many of the important decisions relating to member benefits are taken by the members themselves, including: the amount to contribute, what to invest in (which can change over time), when to take benefits and in what form.

Key points relating to effective communications include:

- be clear about the purpose of communications materials – this helps with providing focus on key messages;
- agree the target audience e.g. differentiate, where appropriate, between DB and DC members or active, deferred and pensioner members;
- communications should be clear, helpful and relevant;
- communications should also be timely;
- agree a suitable method of delivery e.g. paper, electronic, face-to-face; and
- communications should provide members with the information they need throughout their membership of the scheme.

The introduction from April 2015 of the new pension flexibilities for DC benefits have arguably made effective member communication even more important: members with DC benefits have more options, including that of drawing out their entire pension pots in one go. This introduces risks such as: the member misjudging the pace at which the retirement fund can be safely spent, and deplete it too quickly; the member paying excessive tax (for example by drawing down amounts that put the member in a higher rate tax band for that year than he would normally be in); or the member becoming victim to investment 'scams'.

Partly to address this, the April 2015 flexibilities have resulted in significant new disclosure requirements. These relate to 'flexible benefits' (broadly DC or cash balance benefits), and also to defined benefits when the member wishes to transfer his benefit entitlement.

TPR has published an essential guide to communicating with members about pension flexibilities, which aims to provide both information on key changes to the retirement communications and good practice suggestions for communicating with members about their retirement choices.

2.4.2 Disclosure Requirements

From 6 April 2014 most of the disclosure requirements relating to pension schemes are contained in the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 ("the disclosure regulations"). Since these requirements need to be met in detail by those responsible for running pension arrangements, the adviser will normally find that all the information he needs to prepare recommendations for his client will be readily available. If further data is required then normally a simple request for that, probably via his client will complete his factfind. If need be, the adviser could check the detail of the regulations himself and use this knowledge to obtain any missing data.

2.4.3 Different Communication Methods

The adviser will come across different information sources when fact-finding.

Traditional paper based communications are still widely used in the following forms:

- Letters
- Forms
- Leaflets
- Factsheets
- Statements
- Booklets / Guides
- Newsletters
- Reports

Electronic communications are also widely used e.g. emails, websites, intranet sites, SMS messaging, pod casts and automatic data transfers.

However, some members still prefer face-to-face communications via group presentations, meetings or one-to-ones; or by phone.

Whichever methods are used to communicate with members it is vital that the information contained within the communication is consistent.

2.4.4 Giving Financial Advice

In relation to pensions, an individual or company must be authorised by a regulator if they wish to:

- give advice on; or
- arrange transactions of (for example, making arrangements with a view to assisting another person to complete a deal); or
- deal in (for example, buying or selling investments); or
- manage (for example, managing the assets of another person)

Give advice on certain products, including the following:

- insurance policies such as group pension contracts, personal pension plans, section 32 buy outs and FSAVCs, and other long term assurance products with an investment element;
- AVCs;
- investment options in pension schemes;
- group life assurance policies (and some individual policies);
- group permanent health insurance or income protection policies (and some individual policies).

DRRA students will be able to advise on the above activities on successful completion of the DRRA course and subsequent authorisation. The requirements of providing financial advice are considered in detail in Retail Advice and Regulation.

Authorisation is not required in order to advise on, arrange or provide non-financial products and or services (for example, third party administration).

Summary

We began this Chapter summarising the need for saving that included the obstacles to saving and some high level solutions to the issues. We included descriptions of the different options for workplace retirement saving including corporate wraps. Finally, we outlined the main points of effective communication and also the statutory requirements as well as the different methods of communication to engage employees with retirement saving.

Self Test Questions

- What are some of the obstacles to retirement saving?
- Outline the changes to SPA?
- What is the key to effective communication?
- List some of the different methods of communicating pensions information

INTRODUCTION

In this Chapter we look at employers' duties in relation to Automatic Enrolment, introduced with effect from October 2012 by the Pensions Act 2008 and subordinate legislation. The intention is that if employees who are not currently participating in a private pension are automatically enrolled into a suitable scheme, then most will not exercise their right to opt out, and this will result in a significant increase in the numbers who are making some provision for their retirement. To cater for employers who do not have a scheme suitable for automatically enrolling these employees into, the legislation provided for the establishment of 'NEST', which is intended to be a low cost DC arrangement.

3.1 WHY AUTOMATIC ENROLMENT?

The Government's White Paper "Security in retirement: towards a new pensions system" issued in May 2006 set out a new structure for the long-term future of pensions in the UK. The measures aim to provide greater support for lower earners and carers to help these people to save for retirement.The intention is to increase the number of individuals making provision for their retirement (and thereby reduce the requirement for future provision of support from the State).

3.2 THE AUTOMATIC ENROLMENT REQUIREMENTS

3.2.1 Automatic Enrolment

The main features are set out below.

- All 'eligible jobholders' between age 22 and SPA earning more than an amount sometimes known as the 'earnings trigger', who are not already in a suitable pension scheme, will be automatically enrolled into a 'qualifying scheme'.
- This process will be repeated every three years. This automatic 're-enrolment' means that employees who decide not to be in a pension scheme can only do so by repeatedly making a positive decision to opt out.
- For a DC scheme to be treated as a qualifying scheme, after a transitional period annual contributions must be paid of at least 8% of 'qualifying earnings', of which at least 3% must be contributed by the employer. For this purpose, qualifying earnings are gross earnings, including sick pay and statutory maternity, paternity and adoption pay, between a lower and upper limit.
- For 2017/18, the levels of the annual contribution limits are £5,876 and £45,032, and the earnings trigger is £10,000. There is deliberately a significant gap between the earnings trigger and the lower contribution threshold in order to avoid individuals who are earning just over the earnings trigger being enrolled into pension schemes only to receive very low benefits.
- The definition of 'jobholder' includes a wide range of employees, including temporary and agency workers (if working in UK). Jobholders with qualifying earnings who are earning less than the earnings trigger are known as 'non-eligible jobholders', as are jobholders with qualifying earnings who are between 16 and 22 or between SPA and 75. Non-eligible jobholders do not have to be automatically enrolled into a qualifying scheme, but they have to be informed of their right to membership of such schemes. If they take up this right then they will be entitled to receive the minimum employer contribution.Those UK workers aged between 16 and 75 who do not have qualifying earnings (i.e. are earning less than the lower contribution limit) are known as 'entitled workers'. Entitled workers must also be informed of their right to membership of a scheme (but because they do not have qualifying earnings, the employer contribution requirement is zero).
- For most existing pension schemes, the earnings definition for benefits (in the case of DB schemes) and for contributions (DB and DC) is different from the band earnings definition used in the qualifying schemes test. For example, a DC scheme might base contributions on earnings excluding overtime; a DB scheme might base benefits on basic salary less an offset intended to take account of an assumed State pension. For DC schemes, or DC elements of hybrid schemes, it is recognised that having a different pensionable salary definition would cause considerable practical difficulties when trying to decide whether adequate contributions have been made. To

address this employers are able to 'certify' periodically that a DC pension scheme that they are using to fulfil their Automatic Enrolment duties satisfies an 'alternative quality requirement' This alternative requirement is based on the scheme's own definition of pensionable salary provided that this is no less than the individual's basic pay.

- Employers will be able to operate a 'waiting' or 'postponement' period (up to 3 months) starting from the date an individual becomes eligible for Automatic Enrolment. During this period, eligible jobholders do not need to be automatically enrolled although they must be informed of their right to 'opt in' during this period.
- For a DB scheme to be treated as a qualifying scheme, it must either be contracted out or provide benefits broadly equivalent to, or better than, a 'test scheme' when looked at the relevant membership as a whole. Here a test scheme is one that gives a pension payable from age 65 of 1/120 of final qualifying earnings (averaged over the final 3 years of service) for each year of service. The age 65 requirement will be raised to reflect the intended increases to the SPA (see Chapter 1). It is also possible for a CARE scheme to be treated as a qualifying scheme if it is either contracted out or provides benefits equivalent to the test scheme standard. For CARE schemes, there are requirements as to the minimum level of revaluation that must be given if the scheme is to be a qualifying scheme.

From April 2015, 'alternative quality requirements' for DB schemes, based on the cost of accrual, was introduced. To satisfy the alternative test, the scheme needs to provide benefits where the cost of accrual is at least 10% of qualifying earnings. Where the scheme uses other definitions of pensionable earnings, different minimum percentages may apply (for example, 11% where pensionable earnings is basis pay, 9% where pensionable earnings is total earnings).

Where in a DC scheme the alternative to the quality test is being used, the minimum contribution must be at least 9% of underpinned pensionable salary (minimum 4% from the employer); OR provided that underpinned pensionable salary constitutes at least 85% of total earnings, then the minimum becomes 8% of underpinned pensionable salary (minimum 3% from the employer); OR if all earnings are pensionable, then the minimum becomes 7% of underpinned pensionable salary (minimum 2% from the employer). Lower amounts apply during the transitional period, in a similar way to when an employer uses the statutory quality test (i.e. using qualifying earnings).

3.2.2 Anti-avoidance

There are various 'anti-avoidance' measures in place to prevent employers from only hiring those who have signalled their intent to opt out of the pension scheme or from giving 'inducements' to jobholders to opt out.

There is provision in the 2008 Act for pension schemes with an employee contribution rate that is set so high that it might discourage membership to be deemed to have failed the qualifying scheme test.

3.2.3 Transitional Arrangements

There are transitional arrangements, comprising 'staging' and 'phasing'.

Staging describes the process whereby companies became subject to the Automatic Enrolment requirements in stages.

- The largest companies, with PAYE schemes of 120,000 or more, were required to comply with the Automatic Enrolment requirements from 1 October 2012. That was their 'staging date'. Later dates applied to progressively smaller companies until the process was completed for the smallest companies by February 2018
- Employers were able to bring forward their staging dates giving flexibility to align their staging date with some other convenient date or avoid having to use a date that is a particularly busy one for their business.

Where companies were using DC arrangements to discharge their Automatic Enrolment duties, the minimum contribution requirement was ***phased in***. For the period between the employer's staging date and 30 September 2017 the minimum total contribution was 2% of band gross earnings (with 1% minimum coming from the employer); in the year commencing 1 October 2017, the minimum rate became 5% (2% from the employer). Thereafter, the full rate of 8% (3% from the employer) applies.

3.2.4 Automatic Re-enrolment

From the point that the Automatic Enrolment duties apply to a particular employer (i.e. after that employer's staging date, and any postponement period – see 3.2.1. – being operated), there may be some employees not in a qualifying scheme. Of these, some will be eligible jobholders who have opted out; others will be non-eligible jobholders or entitled workers who have not been offered membership and who have not asked to join a scheme.

These two categories of employee are treated differently:

- eligible jobholders who have opted out are automatically re-enrolled on the next cyclical re-enrolment date. The first cyclical re-enrolment date will be a date chosen by the employer within 3 months either side of the 3 yearly anniversary of the employer's staging date. Once the first re-enrolment date had been fixed, subsequent cyclical re-enrolment dates occur every 3 years on the anniversary date;
- non-eligible jobholders and entitled workers remain outside the scheme unless they become eligible jobholders (for example reaching age 22 or starting to receive earnings above the earnings trigger), in which case they are automatically enrolled as under the process described above, or they unless they ask (or are invited) to join the scheme.

3.2.5 Restriction on Charges

- Regulations made under the Pensions Act 2014 cap the charges that can be levied on members' funds in a 'default arrangement' in a DC qualifying scheme from April 2015 to 0.75% p.a. of funds under management. Some schemes do not have operate a simple Annual Management Charge type structure – for example the initial charging structure used by NEST (see 3.3 below) combines a 0.3% AMC with a 1.8% charge on contributions paid in. Provided that the overall effect of such an arrangement is deemed to be broadly equivalent to the effect of an annual charge of 0.75% or lower, it will be acceptable. For this purpose, a default arrangement is any fund which members are put in if they do not express a preference and also any fund in which broadly 80% of members are invested where they do have to make a decision. Once an arrangement has become subject to the cap, the cap will continue to apply even if it subsequently ceases to satisfy the definition of a default.
- Since April 2016, a ban has applied to 'member borne' charges or commission in a DC qualifying scheme.This ban prevents charges from being levied on a member's funds to pay an adviser for services given to the member. The first phase of the ban applies to new charging arrangements or those which are varied or renewed after April 2016.The second phase of the ban which relates to arrangements entered into before 6 April 2016 was introduced from 1 October 2017.
- Members are able to opt out of either or both of the 0.75% charge cap or the ban on member borne charges if they sign a written agreement which satisfies certain conditions. This will enable them for example to receive advice or a service such as one relating to the new flexible drawdown provisions, and to pay for it by a deduction from their fund.
- Pensions Act 2014 regulations also ban so-called 'active member discounts' in DC qualifying schemes from April 2016.An active member discount is usually a differential charging arrangement in a workplace scheme under which former employees suffer a higher level of charges than current employees.

3.3 NEST AND OTHER OCCUPATIONAL MASTER TRUST SOLUTIONS

Following the May 2006 White Paper, in December the same year the Government published a further White Paper: "Personal accounts: a new way to save". This described a new multi-employer workplace pension scheme, initially known as the Personal Accounts Delivery Authority but later renamed National Employment Savings Trust (NEST). Responsibility for running the scheme has been given to the NEST Corporation, a non-departmental public body reporting to the Secretary of State for Work and Pensions.

NEST is a very large multi-employer occupational DC pension scheme. It is one of a number of so called Master Trust arrangements, a handful of which have been designed specifically with Automatic Enrolment in mind. Employers participate in these centralised arrangements, but do not actively appoint or remove trustees or have a role in the management of the scheme. Instead the provider operates a trust corporation and appoints third parties to perform functions such as administration and investment.

NEST is intended to extend the benefits of workplace schemes to those currently without access to them.This is to be achieved by establishing a simple, low cost pension scheme which will be available for all employers whether or not they have suitable alternative pension arrangements.

The intention is that the large scale of NEST will mean that the set up costs can be spread over a long period and recovered from what eventually will be very large funds under management, thus resulting in a low average charge.

Although it is an occupational scheme, it will share the 'portability' characteristics of personal pensions in that individuals will be able to keep their account as they change jobs and can continue to make contributions.

The Government's intention at launch was that NEST complemented, rather than competed with, existing high quality pension provision. To support this, initially there were limitations on transfers in and out of NEST (i.e. members will be restricted in their ability to transfer a pension entitlement already built up in another pension scheme into their NEST account, or vice versa).There was also a maximum annual contribution allowable to a NEST account. For 2016/17, this maximum was £4,900.

However in April 2017, the annual contribution limit was removed and at the same time, NEST removed certain other restrictions which were put in place initially following concerns that NEST was competing unfairly with existing commercial pension providers, primarily the restriction on receiving transfers from other arrangements.

While NEST is the default provider for Automatic Enrolment benefits, other providers (either a specialist department of an established insurer, some of which are listed by TPR in a "find a pension scheme" section on their website) will also need to be considered by advisers.

The main features of the operation of a centralised Master Trust are as follows:

- collection, reconciliation and central functions – a central clearing house would be responsible for collecting contributions through employers, handling employer queries, keeping records of contributions and ensuring that contributions are allocated to the right funds;
- administration of accounts – the administrator would maintain the account for the individual, handle an individual's queries and be responsible for giving them information about their account;
- investment and fund management – the fund manager would invest contributions on behalf of the saver;
- accessing pensions savings – when a saver retires they would convert their savings into income by way of an annuity bought in the open market, giving them regular income throughout their retirement;
- suitable governance arrangements to help avoid potential conflicts of interest that can sometimes exist in such arrangements.

3.4 WHAT AUTOMATIC ENROLMENT MEANS FOR EMPLOYEES

An adviser needs to specifically understand how Automatic Enrolment might affect their clients.

- Employees aged over 22 and below SPA are automatically enrolled if they earn above £10,000 and are not already in a qualifying scheme. This includes temporary and part time employees.
- Employees outside this age band are able to opt in to the scheme and be entitled to an employer contribution if they have qualifying earnings.
- Ultimately, employees in DC arrangements will pay gross contributions of 5% of qualifying earnings which will be accompanied by 3% from the employer. Tax relief applies for all contributions subject to the usual rules. If the employer pays more than 3%, the employee will be able to pay less than 5% (subject the overall input being at least 8%). (NB - The alternative targets of 9% and7% can also be met by the employer paying part of or all of the excess above his minimum portion.)
- Lower rates of contributions are paid during a transitional period.
- Alternatively, some employees are automatically enrolled into DB schemes.
- The band of earnings on which contributions will be paid will be up rated in line with earnings.
- For low earners who would not be otherwise saving, there has been a concern that they would not get value for money from any contributions they made because of the effect on means-tested State benefits that they may have been entitled to. This concern has been addressed partly by increasing the level of the earnings trigger and partly by the decision to deliver a State pension from 2016 at a level above which most means tested benefits are payable (meaning that anything that an individual receives from private pension saving over and above the State pension is unlikely to impact significantly on any means tested benefits).

3.5 WHAT AUTOMATIC ENROLMENT MEANS FOR EMPLOYERS

Where advisers are also considering the needs of corporate clients, the following points need to be borne in mind.

Automatic Enrolment is likely to increase substantially pension scheme take up rates (i.e. the percentage of employees who participate in the scheme), whether to an existing pension scheme or to a new arrangement such as NEST. The reasons for this are twofold:

- First, many more employees will be given access to a pension scheme that their employer will contribute to. Currently, there is no requirement for a company to contribute to a pension scheme for any of its employees (while employers have had to make available a Stakeholder arrangement from October 2001, they had never been required to contribute to one);
- Secondly, it is believed that many employees who would not actively choose to join a pension scheme will nevertheless remain in one if they are automatically enrolled / re-enrolled. In this context, note that there will be statutory provisions in place to prevent employers forcing or encouraging its employees to opt out.

However, working against this will be the feeling amongst some of the workforce, particularly amongst the young and the low earners that they cannot afford to make pension provision when they have other more immediate demands on their finances.

Although the overall take up rates should increase greatly, the actual ultimate rates are currently unknown and will vary from employer to employer, depending on factors such as what pension arrangements the employer is offering and what the demographic profile of its workforce is.

Any increase in take up rates will have a direct impact on the employer's pension costs. Because of this, some have voiced the fear that Automatic Enrolment could in some cases lead to a 'levelling down' whereby employers who are currently making relatively generous pension provision for a section of its workforce decide instead to put all its employees into a pension scheme but to reduce the company contribution rate to a level closer to the eventual 3% of band earnings minimum.

The Automatic Enrolment requirements may also result in a significant additional administrative and compliance burden on companies. This could be particularly keenly felt by small employers who do not currently have a pension scheme. However, the NEST Corporation,TPR and others are working to keep this to a minimum.

Summary

Employer duties in relation to Automatic Enrolment were introduced by Pensions Act 2008 with effect from 2012. The aim is to increase the numbers of individuals who are making their own retirement provision, particularly the lower paid. Master Trusts such as NEST will be a simple low charge product, as Stakeholder pensions were intended to be when they were introduced with similar aims. However unlike previously with Stakeholder pensions, where companies use Automatic Enrolment schemes such as NEST individuals will be automatically enrolled and employers will be compelled to make contributions. Ultimately the success or otherwise of NEST and similar arrangements is likely to depend on what percentage of the target group of individuals allow themselves to remain in the scheme.

Self Test Questions

- Why is Automatic Enrolment being introduced?
- What are the main features of a centralised Master Trust?
- Under what circumstances does an employee not need to be automatically enrolled into a qualifying scheme?
- What is the main impact of Automatic Enrolment for employers?

INTRODUCTION

Broadly, there are two main methods of providing workplace pension schemes in the UK: occupational pension schemes and personal pension schemes. Occupational pension schemes are established by an employer for the benefit of its employees. Personal pension schemes are individual arrangements entered into between an individual and an insurer.

Most occupational pension arrangements are established by the creation of a trust. A trust can be established by:

- a trust deed which is made between the employer and the initial trustees; or
- a declaration of trust by which the employer appoints itself as trustee.

However, most schemes are constituted by a trust deed and a set of rules (which sets out the benefits payable under the scheme and which is normally attached to the trust deed). In both cases the document will set out the terms of the trust.

Some pension arrangements are not set up as trusts. Unfunded schemes and retirement annuity contracts often take the form of a contractual arrangement or promise. Also, there are statutory occupational schemes for public sector employees which are set up by legislation and which do not take the form of a trust. Personal pension schemes can be set up under irrevocable trusts or, if the provider is an authorised insurance company or friendly society, can be established by deed poll.

The most common types of pension arrangement are examined in more detail below.

4.1 OCCUPATIONAL PENSION SCHEMES

An occupational pension scheme is (broadly) a scheme that is established by an employer to provide pensions and other ancillary benefits (e.g. death benefits) for its employees (and their spouses and dependants) and which is administered in the United Kingdom. This definition covers a wide range of pension schemes, including those governed by a letter between an employer and an employee, or a complex pension scheme which provides benefits to all of the employees in a corporate group.

Most occupational pension schemes are regulated by the requirements of the Pensions Act 1995, the Pensions Act 2004 and the Pension Schemes Act 1993. The Pensions Acts of 1995 and 2004 deal with matters such as funding and administration. The Pension Schemes Act 1993 deals with matters such as protection for early leavers (i.e. members who leave their scheme before normal retirement age and who do not take an immediate pension) as well as the requirements relating to schemes which were contracted out of the State second pension.

Occupational pension schemes are commonly described as either DB schemes or DC (which includes money purchase) schemes, depending on the type of benefits they provide. In the former, the amount of pension which the member receives is directly related to pay. For example, a member may receive 1/60th of final pensionable salary for each year of pensionable service. In the latter, the amount of pension reflects the contributions made to the scheme in respect of the member and the investment return on those contributions, which is then used to purchase an annuity from an insurance company. The most important difference between the two types of schemes is how they are funded and what this means for the burden of risk between the employer and the member. Under a DB scheme the majority of the risks relating to funding, investment and life expectancy are on the employer, whereas in a DC scheme the member bears these risks. Hybrid schemes provide both DB and DC benefits. Often these are provided by different sections of the scheme. A quite different type of hybrid scheme is one in which the benefit provided is itself hybrid in nature – for example, where the benefit is the best of a pension calculated on some formula and the proceeds of a DC pot.

In the past, an employee could not generally be a member of an occupational pension scheme if he was also contributing to a personal pension scheme. This position changed as a result of the Finance Act 2004. A person can now be a member of as many registered pension schemes (whether personal or occupational) as they like. There are however annual and lifetime limits on the value of their pensions contributions and savings which qualify for tax relief.

Occupational pension schemes are set up under trust, with trustees or managers appointed to run the scheme. Trustees are required to operate schemes in accordance with the scheme's trust deed and rules, and are also under a fiduciary duty to act in the best interests of members of the scheme. Trustees are responsible for appointing (in some cases) and holding to account (in all cases) those parties who are responsible for the day-to-day running of the scheme.

4.2 PERSONAL PENSION SCHEMES

A personal pension scheme is a pension scheme that is not an occupational pension scheme and which is established by a person with permission under the Financial Services and Markets Act 2000 to establish such a scheme. In practice, this means that personal pension schemes tend to be provided by insurance companies. To set up a personal pension scheme an individual will enter into a contract with the insurer. This will set out the terms upon which the scheme will operate.

Many employers operate a group personal pension plan (GPP) for their employees. A GPP is essentially a collection of personal pension arrangements. An advantage of a GPP is that the employer can name the arrangement, which can give it the feel of an occupational pension scheme. GPPs also tend to have lower administration charges than individual personal pensions.

Employers who offer a GPP for their workers may establish a management committee. A management committee is, like a board of occupational pension scheme trustees, comprised of a group of skilled and knowledgeable people who meet regularly to review the way a pension scheme is run and governed. In most cases there will be no contractual arrangement between the management committee and the pension provider, and the provider is not required to follow the management committee's proposals.

With effect from 6 April 2015 firms operating workplace personal pension schemes (excluding individual personal pension schemes) are required to establish and maintain an Independent Governance Committee "IGC". (Smaller and less complex workplace personal pension schemes are able to establish a Governance Advisory Arrangement, or GAA, instead of an IGC.) Although IGCs will be established by firms they will have a contractual duty to act independently of the firm and in the interests of relevant scheme members.

Like occupational pension schemes, personal pension schemes must be registered with HMRC in order to benefit from favourable tax treatment. A person may become a member of a personal pension scheme at any time.

4.2.1 Personal Pensions for Individuals

Personal pension schemes were originally established so that anyone could save for an income in retirement provided that they had 'relevant earnings' (broadly UK taxable earnings, with some exceptions) and provided that those earnings arose from non pensionable employment. Personal pensions were introduced from 1 July 1988 to replace retirement annuity contracts (pre-existing retirement annuity contracts were able to continue). They all operate on a DC basis.

A personal pension can be established under irrevocable trust, by deed poll or, in Scotland, by a board resolution. A personal pension set up under trust may itself be under a master trust, or may consist of individual trusts for each member. To take advantage of the tax reliefs available, the personal pension must be a 'Registered Scheme'. Existing 'approved' personal pensions automatically became registered schemes on 6 April 2006.

Originally, personal pensions were meant to provide benefits on retirement, death or disability for the self-employed and for employees who were not members of an occupational pension scheme. One consequence of this was that if someone was already a member of his company's occupational scheme, the only way that they could join a personal pension scheme was by leaving or 'opting out' from the company scheme.

Regrettably, some people took this course in the late 1980s or early 1990s in spite of the fact that by doing so they would normally cease to benefit from any employer contribution to their retirement provision (at the time, employers who sponsored an occupational pension scheme would not normally contribute to a personal pension taken out by an employee opting out of the occupational scheme).Where an individual was advised to opt out and also took a transfer from the occupational scheme, their case had to be subsequently reviewed. Often compensation was paid and the sheer number of such cases led to this being referred to as the pensions mis-selling scandal.

Guidelines were produced for how to identify and compensate those who had received poor advice, and companies involved in sales of personal pensions were instructed to review relevant cases. Where the review identified that the person had been disadvantaged financially by opting out of an occupational scheme, or transferring their benefit entitlement out, the adviser had to offer to rectify the situation. This took the form of paying for the employee to be fully or partially reinstated into the employer's scheme or, if this was not possible, by paying a compensation payment into the personal pension scheme.

In April 2006 restrictions on concurrent membership of pension schemes were removed completely and there is now no limit to the number or type of pension arrangements of which a person may be a member.

4.2.2 Personal Pensions for Groups of Employees

Often an employer wanting to make pension provision for its employees will do so by using personal pensions. In this case, a GPP is usually the preferred vehicle.

A GPP is a collection of individual personal pensions which have been taken out with the same pension provider (normally an insurance company) and which were taken out for the employees of one particular company or group of companies. The benefits of scale, and in particular efficiencies on the sales and marketing side, mean that the terms offered by GPPs will often be better than those that could be obtained by employees setting up personal pensions on an individual basis through their own financial adviser. The employer in any event will very probably appoint a financial adviser or employee benefits consultant to assist in any choice of GPP: this will protect the employer from any suspicion of providing financial advice – illegal for anyone not authorised.

Historically it has been quite common for the enhanced terms to only be available while the member is an employee of one of the companies participating in the GPP – a so called 'active member discount.' However from April 2016 this practice has not been allowed in relation to schemes used for Automatic Enrolment.

Usually, the employer will contribute to the GPP and these contributions will normally be deductible against corporation tax.While a GPP is not an occupational pension scheme, it shares some of the characteristics of one. In particular, the GPP can often be 'branded' with the company's name and logo and, to the member, it appears much like an occupational DC scheme.

Unlike most occupational schemes, contributions made to GPPs by members are made from their net earnings. Members' contributions are then grossed up in respect of basic rate tax by the pension provider. In other words, every £80 actually contributed by the member is grossed up to £100 by the provider (based on the 2017/18 basic tax rate of 20%).The provider then reclaims this tax from HMRC. This is known as 'relief at source'

Higher and additional rate tax payers can claim further tax relief either through their tax assessment or by writing to HMRC to request an adjustment to their tax code.

Note that this tax treatment differs from that which applies to most occupational pension schemes. In the case of these arrangements, members' contributions are usually made from gross earnings and are offset against the member's taxable earnings. So a member wishing to make a gross contribution of £100 would have this amount paid from their salary and their income tax liability would be based on the residual earnings. This is known as the 'net pay arrangement'.

Although almost all occupational schemes use the net pay method, this is not mandatory. NEST is an exception in being a trust-based occupational scheme that operates on a relief at source basis. All personal pensions (including GPPs) use relief at source.

4.23 Self Invested Personal Pensions (SIPPs) and Income Drawdown

SIPPs were introduced following a Government initiative announced in the 1989 Budget, which was intended to make it easier for members of personal pensions to control their own pension fund investment.

We consider this complex SIPPs option in detail in Retail Advice and Regulation.

4.24 Authorised Provider

Only an 'authorised pension provider' may establish a personal pension. Before 6 April 2001, this had to be a provider who was authorised under Chapter III of Part I of the Financial Services Act 1986 to carry on investment business. These are usually:

- insurance companies;
- building societies;
- banks;
- unit trusts;
- friendly societies.

There are, however (since April 2001), no longer any such restrictions on who can establish a personal pension provided it is set up under a trust.

4.25 Payment of Personal Pension Providers

The way providers receive income will differ with the type of provider and the age of the contract. Charges historically have been usually taken in the following ways:

- Insurance companies – from the premiums paid into their products or the money invested in their funds.
- Building Societies and Banks – from the premiums paid into their products or the money invested in their funds or fees earned from other providers
- Unit Trusts – from the bid/offer spread and money invested in their funds.
- Friendly Societies – as for insurance companies.

Other costs will be levied by other advisers. For example, financial advisers may be paid by hourly rates, a percentage of the customer's investment a fixed fee plus annual review fee, but not commission, which has been banned since 1 January 2013 following the Retail Distribution Review. Since RDR, clearer exposition of charges, transparency, has been the FCA's target and generally all investment products are moving towards annual management charges avoiding any upfront or exit fees unless such charges are specifically agreed.

4.26 Retirement Annuities

The retirement annuity was the forerunner to the personal pension: employers were not normally involved in any way, the contracts being set up between the individual and provider. No new retirement annuity contracts have been permitted from 1 July 1988, although contributions to existing policies were allowed to continue, and many such contracts are still in existence.

Historically, retirement annuity contracts (sometimes also referred to as 'section 226 policies') were set up by insurance companies principally for the self-employed. There were differences between the rules governing personal pensions and retirement annuities, including the following:

- employer contributions to employees' personal pensions were not treated as a benefit in kind unlike contributions made to retirement annuities; in practice, this meant that employers did not contribute to retirement annuities direct;
- retirement annuities were only available to adults; personal pensions may be effected by or on behalf of minors;
- a retirement annuity was never able to contract out of SERPS/S2P, whereas (until 6 April 2012) a personal pension could:
- retirement annuities were set up with a minimum retirement age of 60, whereas personal pension benefits could usually be taken from age 50 (although from 2010 the minimum age that retirement benefits can normally be taken from was increased to 55);
- the amount that could be taken as a tax free cash sum at retirement was calculated differently: rather than 25% of the fund, the tax-free cash was generally expressed as three times the maximum available annuity.

Since April 2006, there are no longer any statutory differences between the two types of arrangement, although in many cases the policy provisions will still reflect the legal position in force at the time the policy was taken out.

4.27 Stakeholder Pensions

From 8 October 2001, every employer with five or more employees which did not provide an occupational pension scheme for its employees nor contribute at least 3% of earnings to a GPP, had to designate a Stakeholder pension scheme for its employees, consult with employees, permit access to the scheme and make arrangements for employees' contributions to be deducted from their pay (if the employee opted to join – it was not compulsory) and remitted to the Stakeholder scheme provider. The employer was not obliged to make contributions to the scheme, which meant that many Stakeholders remained empty shells.

A Stakeholder pension scheme is essentially a personal pension scheme which satisfies certain minimum standards (for example, in relation to charges). However, as a result of the introduction of the employer's Automatic Enrolment duty the Stakeholder requirement was abolished from 1 October 2012 in relation to new members, though existing members must be allowed to remain in the scheme.

Between 2012 and 2018 all employers were required to start to automatically enrol eligible workers into a qualifying scheme (i.e. an occupational or personal pension scheme which fulfils the qualifying conditions). Eligible employees who opt out will be automatically re-enrolled every three years. The Automatic Enrolment duties, which (unlike the Stakeholder duties) include requirements for employer contributions, are being phased in, starting with the largest employers. The Automatic Enrolment requirements are dealt with in Chapter 3 above.

Summary

Personal pensions can be set up on a group or individual basis. They include Stakeholders and SIPPs. They replaced retirement annuities and were originally for those who were in non-pensionable employment. Now anyone can take out a personal pension.

Stakeholders are an obsolescent type of personal pension satisfying certain criteria, principally what historically were regarded as low charges and acceptance of small contributions. Unless exempted, between 2001 and the introduction of Automatic Enrolment in 2012, employers with five or more employees had to 'designate' a Stakeholder scheme and facilitate membership for any of its employees who want to join. However, there was never any requirement for employees to join and if they did, no requirement for employers to contribute. Many Stakeholders are 'empty shells'.

Only authorised providers can establish a personal pension by deed poll (or board resolution).

Self Test Questions

- What is the difference between group and individual personal pensions and the circumstances in which each might be used?
- Outline the mechanism whereby an individual benefits from the tax relief given to contributions paid to a personal pension and explain how this differs from a member contributing to an occupational scheme.
- What are the similarities and differences between personal pensions and retirement annuities?

INTRODUCTION

In this Chapter we examine the different benefit structures found in workplace pension schemes. We describe the two most common structures, which are the DB design (including final salary or average salary schemes) and the DC design (which is also referred to as money purchase).We also cover hybrid schemes, which provide benefits on both DC and DB bases. We go on to describe the different types of workplace pension scheme that you might expect to encounter.

5.1 BENEFIT STRUCTURES FOUND IN WORKPLACE PENSION SCHEMES

5.1.1 Defined Benefit Pensions

DB arrangements are always occupational schemes. The term 'defined benefit' means that the pension provided is calculated by reference to a formula set out in the scheme's rules, rather than being directly related to the amount of contributions paid or the investment performance of the assets held in the scheme's fund. There are two types of DB arrangement commonly used in the UK: final salary and career average.

Funding DB schemes

Generally in a DB scheme of whatever type, members contribute at a fixed rate. The contribution rate is set out in the scheme's rules. However, although the rate at which benefits accrue is known in advance, the ultimate cost of providing them is not. The employer's contribution rate is variable, and is determined by an actuary on a periodic basis. Although the contribution rate is variable, typically the ongoing rate is significantly higher than that paid by members with this difference often being greatly magnified when deficit reduction contributions (which are paid by the employer when the scheme is underfunded) are taken into account.

5.1.2 Final Salary Schemes

This has been historically the more common type of design (although in recent years career average schemes have grown in popularity). Such has been its dominance in the past that it is sometimes mistakenly believed that the terms 'final salary' and 'defined benefit' are essentially synonymous.

The amount of pension provided on retirement is calculated by reference to a formula:

Pension = N x Accrual Rate x Final Pensionable Salary

Where:

N is the length of time that the member has been a member of the scheme, and is usually described as Pensionable Service

The **Accrual Rate** is a fraction – commonly sixtieths or eightieths or hundredths – or a percentage say 1.5%

Final Pensionable Salary (FPS) is based on the member's salary at the time the member leaves the scheme. The exact definition varies from scheme to scheme, but common definitions are based on basic earnings as at a specified date in the preceding year or an average of basic salary over the final 12 or 36 months of scheme membership. In some cases, part of basic earnings may be omitted from the definition of FPS. For example, an amount equal to the Lower Earnings Limit may be disregarded. It should also be noted that gross earnings, which may vary from year to year due to bonuses and overtime, are sometimes used to calculate FPS.

In the case of a member who leaves a 60th accrual scheme after 30 years' membership with an FPS of £30,000, the benefit calculation will be:

Pension = 30 / 60 x £30,000 = £15,000 p.a.

5.1.3 Career Average Revalued Earnings

Career Average Revalued Earnings (CARE) schemes are an increasingly popular alternative to final salary schemes. Major examples in the private sector have included the schemes sponsored by Tesco and the Co-Operative Group (and following the Hutton review and the Public Services Pensions Act 2013, most public sector pension provision will be made through CARE schemes in the future – indeed, while protecting employees within ten years of retirement at 1 April 2012, changes have been made with effect from 2015 to the NHS and Teachers' Pension Schemes, towards later retirement dates, greater employee contributions and use of CARE rather than final salary). The principal difference when compared to a final salary arrangement is that benefits reflect earnings throughout the period of membership rather than just in the period preceding the date of exit. A typical design is summarised below. The example arbitrarily uses an accrual rate (see above) of 1/80th and a scheme anniversary of 1 April; in practice these – together with the definition of Pensionable Salary and the Revaluation Rate – will be formally defined in the scheme rules.

Year One

A member joins the scheme on 1 July (three months after the scheme anniversary of 1 April). His Pensionable Salary at the following anniversary is £25,000. At that time, his accrued benefit for the scheme year is calculated as:

(9/12) x 1/80 x £25,000 = £234.38 p.a.

Year Two

By the next scheme anniversary, the member has a salary of £26,000. His accrued benefit during his second year of membership is calculated as:

1/80 x £26,000 = £325.00 p.a.

At the same time, the benefit accrued during the first year is revalued. For the purposes of this illustration, it is assumed that the Revaluation Rate is equal to the increase in the Retail Prices Index (RPI), which is itself assumed here to have been 3.5%. This is then added to the most recently accrued benefit to form a 'running total'. The total accrued benefit at the most recent scheme anniversary is therefore:

Year one's benefit	£234.38 x 1.035	£242.58 p.a.
Year two's benefit	£325.00	£325.00 p.a.
Accrued total		£567.58 p.a.

On each subsequent scheme anniversary, the aggregated 'running total' is revalued and added to the benefit accrued over the course of the most recent scheme year.

The appeal to employers of this design compared with a final salary alternative is that it remains possible to offer a DB scheme whilst maintaining a measure of predictability and so more control over costs. This is because in a final salary scheme the accrued liability in relation to any member is difficult to ascertain with certainly as it depends on future earnings received in the period prior to the date of leaving or retiring (a date that is difficult to predict). Furthermore it is difficult for the scheme to make investments that are expected to match future earnings growth with any certainty. In contrast, with a CARE scheme, the liability that has accrued will usually increase in line with price inflation and will not depend on the date the member leaves the scheme. In addition, finding investments which are expected to match or exceed inflation-linked liabilities is in theory relatively straightforward.

A CARE scheme design may also be suitable if the employees have varying earnings patterns due to changes in working hours or bonuses and overtime over their period of membership. For example, the remuneration of some manual workers may have a significant element of overtime which often decreases with age. In this situation, effectively averaging the remuneration over the working lifetime may be preferable.

It can also be argued that CARE schemes have become more appropriate relative to final salary schemes as the number of jobs that individuals can expect to have over their working lifetime has increased. This is because changing jobs tends to have more effect on the benefit provided by a final salary scheme then it does under a CARE scheme. This results from the fact that under a final salary scheme, each year's accrual increases to retirement in line with the individual's salary if he remains with that employer and in line with price inflation if he does not. Over a long period, there can be quite a significant difference. Compare with a CARE scheme, where each year's accrual will be increased to retirement date in line with inflation irrespective of when the individual leaves the employer.

5.1.4 Defined Contribution Pensions

Pension schemes established on a DC basis are also referred to as money purchase arrangements

A DC pension arrangement determines a member's ultimate retirement benefits by reference to a certain level of contributions paid into the arrangement by and/or on behalf of the member, which are then usually increased by an amount based on the investment rates of return achieved on those contributions over a period of time, thus establishing a fund with which to provide benefits. In other words, what the member gets at retirement depends on the size of their fund at retirement. The fund can increase or decrease depending on market conditions and it is not possible for the member to know in advance what the overall return on the fund will be (and hence the size of the fund at retirement).

Furthermore, in the past at retirement most of the fund will need to be converted into income. Historically, this has usually been done by purchasing an annuity. As this will usually depend on the annuity rates available at the member's retirement date, this represents another area of uncertainty for the member. Historically therefore, scheme designs have included default lifestyle to mitigate this risk (see below).

The funding characteristics of a DC scheme are the exact opposite of those for a DB scheme. Because contribution rates for members and the employer are pre-agreed (e.g. set out in employment contracts), the cost of running the scheme can be easily predicted. However, the amount of pension that will ultimately be paid to the member will be subject to a range of variables such as:

- the period of time over which contributions are paid
- investment growth within the fund
- the timing of the member's retirement
- where an annuity is chosen, annuity rates (the conversion factor used to determine the rate of income to be provided by the member's fund) at the time of retirement.

This means that although the cost of the scheme is known in advance, the amount of benefit provided is not.

The most common solution to the problem of volatility in asset values and annuity costs close to retirement has been the use of 'lifestyle' funds. Lifestyle funds gradually switch the member's account into a mix of assets that matches the type of benefits expected to be paid out. For example, if you assume that the member will use 75% of their funds to purchase an annuity at age 65 and take the remainder as a cash sum, then the aim might be to gradually switch 75% of the funds into long-dated bonds over the 5-10 year period prior to age 65. The idea is that, while this type of investment might not be expected to give the highest return over the long term, changes in its value near retirement should match changes in annuity prices. The remaining 25% of their funds could be gradually switched into a cash fund.

Any changes to the expected retirement date in the 5-10 year period before that date, or to the form in which benefits will ultimately be taken (e.g. drawdown or annuity) will require the lifestyle strategy to be modified, possibly with the help of a financial adviser.

Following the changes from April 2015, it is expected that many more members will decide at retirement not to buy an annuity but instead use the new 'pension freedoms' to access some or all of their pension in the form of a lump sum, which can be done at any time from age 55. The uncertainty in how and when any particular member will decide to access his benefit makes the design of future default funds highly problematic. Again, particularly if the member is considering switching pension investments to a SIPP (if it is not already invested in that type of contract), financial advice is highly desirable. Any transfer from a defined benefit scheme (other than a public sector scheme where transfers out are not allowed) to a money purchase SIPP must have the advice of a financial adviser unless the value to be transferred is less than £30,000.

Examples of DC pension arrangements can include personal pension plans, Stakeholder pensions as well as occupational money purchase schemes. NEST and other master trust vehicles set up for Automatic Enrolment are DC arrangements.

5.1.4 Cash Balance Schemes

Some employers in the UK have turned to cash balance plans. Although cash balance schemes are DB schemes, they share some characteristics of DC schemes. Like DC schemes, contributions are paid each year by the employee and employer, are invested, and at retirement the member is provided with a cash sum which is then used to provide a pension.

However unlike DC schemes, the cash sum at retirement is defined at the outset, and does not depend on investment returns. The employer will pay in whatever level of contributions is necessary to provide this lump sum

For example, a company might set up a cash balance scheme where members pay 5% of salary each year and in return get a lump sum at age 65 of 20% of final salary for each year of membership. So a member with ten years' service when he reaches age 65 will have a pot equal to twice his final salary, and will use this to buy a pension (although in common with other schemes, part of the benefit can usually be taken in the form of a lump sum).

Alternatively, the rules might set out what the employer's minimum contribution rate is and also stipulate a rate of investment return to be allocated, for example 7% p.a.. This alternative cash balance structure is also DB, because it is possible to work out in advance what benefit (expressed in cash terms) the member will get for a given number of years' service and for a given salary.

In either case, the sum of money available to provide benefits for the member at retirement is calculated in accordance with a formula. This is fundamentally different from a DC arrangement, where the fund at retirement depends on the investment returns actually earned, and cannot be known in advance.

However, although the cash value of the benefit at retirement is defined, the amount of pension that the member will receive is not known in advance, and will depend on market conditions prevailing when the member retires. In this aspect, a cash balance scheme is more like a money purchase scheme than a DB scheme such as a final salary or CARE scheme.

5.1.5 Hybrid Schemes

A hybrid scheme is an occupational pension scheme, which offers both DC (money purchase) and DB (final salary or CARE) benefits. It may also be referred to as 'mixed benefit' occupational pension scheme.

DB schemes which provide AVC benefits on a DC basis are technically also hybrid schemes, but in most contexts this type of scheme would not be described as such.

With the decline in DB benefit provision, a common type of hybrid scheme is one which has a DB section that is closed to new entrants with all new members after a certain date being put into a separate DC section of the scheme. It would then not be uncommon in time for the original DB section to be made 'paid up', i.e. no further benefits are accrued under it, with all benefit accrual after a certain date being provided on a money purchase basis in the DC section.

Alternatively, a hybrid scheme can be one where the benefits are calculated as the better of two alternatives, perhaps comparing the benefits available on a DC basis to those available on a DB basis. One example would be a scheme that offers DC benefits funded by an annual member contribution of 5% of salary, and an employer contribution of 10% of salary, but with an '80ths underpin' – in other words, the members would receive the proceeds of their DC 'pot' but with a guarantee of a pension of at least 1/80th of pensionable salary for each year of service.

Care is needed not to confuse DB/DC underpin schemes with schemes that have separate DC and DB sections. These types of arrangement are quite different in character, although the term 'hybrid' might be used to refer to either.

5.2 PRINCIPAL RISK CHARACTERISTICS OF PENSION SCHEMES

There are a number of types of risk associated with pension schemes.

In DC schemes, the main risk is that the eventual benefit will be less than the benefit the member had been expecting, either due to poor investment performance, insufficient contributions or because of an increased price of annuities at the time of retirement. This risk is borne by the member, in the sense that it is the member who stands to lose if investment performance is poor, annuities expensive or he outlives the fund.

In DB schemes, the main risk is that the cost of providing the promised benefits will be more than had been budgeted for.This might be due to adverse investment conditions, inflation (see below) or because the mortality assumptions used in the scheme funding calculations turn out to be incorrect. (If pensioners live longer than had been expected, this impacts on the scheme funding and ultimately on the financial demands made of the sponsoring employer.) A major DB funding issue has been changes in legislation which have significantly increased liabilities, including: protection for leavers. Prior to 1975 preservation of benefits on leaving service was optional for employers/trustees and when it became mandatory in the Social Security Act 1973, it was only for leavers who had attained the age of 26 with more than five years' service and who did not wish to take a refund of their own pre-6 April 1975 contributions. Revaluation of leavers' benefits, employer debts for funding shortfalls on wind-up and Pension Protection Fund Levies (the list is not exhaustive) followed.

However, the DB member is not completely protected from risk, since where the pension scheme is not fully funded (i.e. its assets do not cover its liabilities), there is a danger that the sponsoring employer could fail leaving the scheme unable to meet its liabilities in full. But, as indicated in the previous paragraph, for most members this risk is substantially mitigated by the existence of the Pension Protection Fund (discussed in Retail Advice and Regulation).

In hybrid schemes, risks to both the employee and employer can exist. For example, in a DC scheme, which has a DB underpin, poor investment performance represents a risk to the member in that it will decrease the value of their DC fund. The member risk is, however, limited by the presence of the DB guarantee. At the same time, poor investment performance represents a risk to the employer since it makes it more likely that the member's benefit will need to be 'topped up' to the level of the underpin. This also makes the cost of funding that underpin more expensive. However, in most hybrid scheme designs the risk borne by the employer will be much less than it would be in a comparable pure DB scheme.

Inflation can represent a risk for both members and scheme sponsors. In a DB scheme, pensions may be increased in line with price inflation both between a member leaving the scheme and starting his pension ('revaluation') and after the pension has come into payment ('escalation'). However, higher than expected inflation can increase the cost to the employer of funding the scheme and in consequence, both revaluation and escalation are often subject to caps, of perhaps 5% p.a. or 2.5% p.a.. Where this is the case and inflation goes above the relevant cap, higher inflation represents a risk to the member, since the annual pension increases will be limited to the cap and therefore the 'purchasing power' of the pension will gradually decrease over time.

In DC schemes, the inflation risk is borne by the member unless he has used his fund to purchase annual increases (such as fixed percentage) or a fully 'index-linked' pension (in which case the insurance company bears or shares the risk, although this is reflected in a commensurately large annuity purchase price).

5.2.1 De-Risking Defined Benefit Schemes

In recent years issues such as poorer investment returns than anticipated and projected increasing life expectancies have resulted in a significant increase in costs to sponsors of DB schemes. This has contributed to the closure of many DB schemes, whereby either no new employees are allowed in (the scheme is closed to new entrants) or benefits cease accruing under the scheme altogether (the scheme is said to be closed to future accrual). In some cases the scheme remains open, but with future benefits accruing at a lower rate.

The increased cost pressures have also resulted in an increase in so-called 'de-risking' activities. Here an employer reduces its pension risk exposure by one or more of the following methods:

- making a payment out of the scheme in return for a reduction in an inherently risky liability;
- retaining the liability but paying some other party to take on the risk element; or
- acquiring an asset that in some sense 'matches' the liability in the sense that when the cost of the liability changes the value of the asset held changes in tandem.

Some examples of de-risking strategies are outlined below.

- ***Insurance type solutions***
  In a buy-out or buy-in, liabilities are either taken on by an insurance company or kept within the scheme but risk is reduced either by using conventional insurance policies such as annuities or by way of products such as 'longevity swaps'.

- ***Enhanced Transfer Value & Pension Increase Exchange exercises***
  In an 'enhanced' or 'incentivised' transfer value exercise, deferred pensioners who agree to transfer out to another pension scheme are offered an enhancement to the amount available for transfer. In a pension increase exchange exercise, pensioners are offered a one-off increase to their pensions in exchange for giving up their rights to receive certain pension increases in the future.

In response to concerns that undue influence could sometimes be brought to bear on members to make decisions that may not be in their long-term interests, TPR has issued guidance on such exercises. An industry working group has also issued a Code of Good Practice on Incentive Exercises. The code, which has the TPR's support, is voluntary; however there is an expectation that incentive exercises will follow the spirit and principles of the code. Retail Advice and Regulation considers this aspect in more detail.

- ***Liability Driven Investment***
  Here the aim of the investment strategy is to match the risk characteristics of the investments to those of the liabilities. (This has the effect of reducing the amount of uncertainty in the future funding levels of the scheme.)

5.3 TYPES OF WORKPLACE PENSION SCHEMES

5.3.1 Public and Private Sector Pensions

Types of Public Sector Schemes

A public service pension scheme is a statutory occupational scheme that provides benefits for the employees and former employees of central Government, local authorities and various public bodies, including employees of the health service, teachers, the police and former employees of nationalised industries.

Public sector schemes, for employees of the State and its agencies, include some of the oldest and some of the largest group schemes such as the Principal Civil Service Scheme, the Police Pension Scheme and the Firemen's Pension Scheme.They are divided into:

- Statutory schemes, which are constituted by statutory powers (an Act of Parliament, a Statutory Order or a Statutory Instrument).
- Non-statutory schemes, which are constituted by a trust deed and rules and conform with normal HMRC requirements, for example, the trust-based Universities Superannuation Scheme.

Features of Public Sector Schemes

We summarise below the common features of Public Sector schemes prior to the changes introduced by the Public Services Pensions Act 2013.

- The 'pay as you go' system is used by many public sector schemes – benefits are payable from the public purse as they fall due, rather than from a fund built up from employers' and employees' contributions paid in the past and then invested.
- Pension age historically has usually been 60 for both men and women, and can be earlier (for example the police, fire fighters, and armed forces). However from 2006, for new entrants to many public sector schemes, the pension age has been increased to 65.
- Pension is typically calculated as 1/80th of final pay for each year of service, with an additional lump sum of 3/80ths for each year.
- Ill health early retirement provisions can be more generous than the private sector.
- Benefits accrued in many of the larger public sector schemes are fully 'inflation proofed.' Both pensions in payment and deferred benefits are guaranteed annual increases in line with increases in the Retail Prices Index (RPI).This was introduced by the Pensions (Increase) Act 1971.
- Many public sector pension schemes belong to the 'transfer club.' This means that all schemes use a common basis for calculating transfers in and out of schemes. Periods of service accrued in one club scheme may frequently be reproduced exactly following a transfer to another.

Public Sector Pensions Reform

Following concerns about the rising cost of pension provision in the public sector, the Chancellor announced in the 2010 Budget that Lord Hutton would chair an independent commission to undertake a "fundamental structural review" of public service pensions. In March 2011, Lord Hutton published his final report setting out recommendations for public service pension provision that is "sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights".

Legislation followed in the form of the Public Services Pensions Act 2013. The main provisions of the Act are set out below.

- The main existing public service schemes may not provide benefits in relation to service after 31 March 2015 (or service after 31 March 2014 for the Local Government Pension Scheme)
- The Act provides for regulations to be made to establish new schemes: most are CARE schemes
- In general, Normal Retirement Date will be linked to SPA, with some exceptions for members of the police, fire fighters and armed forces.
- A cost control mechanism will keep the ongoing cost to the employer of the schemes, when measured as a percentage of pensionable salaries, within defined margins.

The Government has also moved away from using the RPI as the inflation measure on which public sector pension increases are based, employing instead the Consumer Prices Index (CPI). For technical reasons, in the long term the CPI is expected to increase at a somewhat slower rate than the RPI.

Private Sector

Private sector occupational pension schemes are usually not governed by special statutes; they are generally established by trust.

While public sector schemes include some of the oldest and some of the largest group schemes, the greatest number of schemes is in the private sector. According to the Office of National Statistics' 'Pension Trends' survey, in 2011 (so before Automatic Enrolment had started) there were 8.2m individuals actively accruing benefits in occupational pension schemes (this does not include other workplace pension schemes such as GPPs or Stakeholder schemes). Of these, some 2.9m were in the private sector. The numbers, particularly those relating to private sector DC schemes, have since been swelled by the roll out of Automatic Enrolment

Private sector schemes may be of DB, DC or hybrid design. They may cater for entire workforces or groups of employees (such as those at one site, or the executives of the company). They may provide benefits to the employees of one company, two or more related companies or groups of unrelated employers.

Design of Private Sector Schemes

Private sector scheme sponsors have considerable freedom over scheme design. However there are legal constraints, including:

- pensions tax legislation (principally the Finance Act 2004)
- DWP pensions legislation (for example the Pensions Acts)
- other non-pensions UK and EU law, such as general trust or contract law, employment law, anti-discrimination law etc.

Where legal constraints exist that might be restricting the introduction of novel scheme designs, these are being looked at by the Government as part of its 'reinvigorating workplace pensions' initiative (see 5.2.2 above).

Considerable flexibility already exists in the current legal framework, however, for example in the areas we have set out below.

- Should members contribute ('contributory') or not ('non-contributory')?
- What normal retirement age should be adopted?
- If the employer does not yet need to comply with the Automatic Enrolment duties (see Chapter 3 above) then questions that need to be asked include: Who should be eligible to join and when? Some may decide that employees should join immediately they are employed; others may specify a 'waiting period' or other eligibility condition (such as a minimum or maximum age). But even when the Automatic Enrolment requirements do apply, some of these types of questions are still relevant, since:
  (i) the employer can always be more generous that is required by Automatic Enrolment (e.g. allowing in employees who are not eligible for Automatic Enrolment); and
  (ii) it may be that the employer is not using the scheme in question for Automatic Enrolment (a different arrangement could be being used for compliance with the employer's statutory duties)
- Should benefits be uniform or varied by category of membership (for example, executives or senior staff, or salespeople or other groups of employees)?

Furthermore, from April 2015 DC schemes have been able to offer their memberships even more flexibility in terms of options at the decumulation stage (i.e. when members start to take benefits from their funds, as opposed to the accumulation stage, where they are building up their funds by contributions and investment returns).

Whatever design features it adopts, the employer can distinguish between groups of members. A single scheme, for example, could have:

- a 'works' category, which provides money purchase benefits, where the members pay 2%, the employer pays 5% and the retirement age is 65;
- a 'staff' category, which provides a contracted in final salary benefit with an n/60ths accrual rate, a 5% employee contribution rate and a retirement age of 65;
- an 'executives' category, which provides final salary benefit with a higher accrual rate (such as n/30ths) , no employee contributions and a retirement age of 60;

with the single scheme supplemented by:

- a top up benefit for executives using a separate 'Executive Pension Plan;
- (while using one scheme for employees who satisfy specified eligibility criteria and who have actively applied to join it) a different scheme being used to 'automatically enrol' other 'eligible jobholders' (see Chapter 3, above).

5.3.2 Master Trusts

In considering Automatic Enrolment earlier in this manual, reference was made to the use of Master Trust arrangements.

A master trust is a multi-employer trust-based pension scheme under which each participating employer has its own, effectively ring fenced, section. Benefits are usually provided on a DC basis. There is a single professional trustee board that is responsible for administering the scheme, selecting service providers and selecting the range of investment options, while each participating employer determines the eligibility criteria and contribution rates for its section. Master trusts are not subject to the member-nominated trustee requirements. Master trusts therefore offer a trust-based structure with some of the benefits of a contract based scheme in terms of cost savings and a reduced administrative burden for employers.

TPR and the Institute of Chartered Accountants in England and Wales have produced an independent assurance framework for master trusts. Although this is a voluntary framework, the regulator expects master trusts to obtain independent assurance demonstrating that the scheme is of good quality.

To improve member protection, the Pension Schemes Act 2017 provided for:

- an authorisation and supervision regime, requiring Master Trusts to demonstrate to the Pensions Regulator (TPR) that they met certain key criteria
- Trustees to be required to take certain actions to protect scheme members in the event of wind-up
- TPR to have greater powers to take action where key criteria were not met.

5.3.3 Cross Border Schemes

A cross border scheme is a scheme that is designed to allow cross border activity. Cross border activity for these purposes is generally undertaken:

- where a multi-national company operates in a number of EU Member States through subsidiary companies and wishes to consolidate pension arrangements in one Member State; and
- where an employer in one EU Member State wishes to site its pension scheme in another Member State for commercial reasons.

Requirements

Any occupational scheme with its main administration in the UK which wishes to engage in cross border activity must:

- be registered by a relevant supervisory body;
- ensure that all technical provisions are calculated by an actuary or auditor on the basis of actuarial methods that are recognised by the Member State;
- be effectively run by persons of good repute (meaning persons who either have professional qualifications and experience or persons who employ advisers with suitable qualifications and experience);
- be governed by properly constituted rules regarding its operation, where the members have been informed of those rules;
- provide that, where the sponsoring employer of a scheme guarantees the payment of benefits under it, that employer must also be committed to meeting the costs of those benefits regularly; and
- ensure that scheme members are sufficiently informed of the conditions of the scheme, in particular concerning:
  - the rules and obligations of the parties involved in the scheme;
  - the financial, technical and other risks associated with the scheme;
  - the nature and distribution of those risks.

Numerous sections of the Pensions Act 2004, including most of those relating to investment and scheme funding, derive from the European Pensions Directive (also known as IORP, as its correct title is the Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision). An EU directive is a legal instrument which lays down principles which member states must implement through their own domestic legislation (though in certain circumstances provisions of a directive may have direct effect, i.e. apply in a member state even though no domestic legislation is in place).

One requirement of IORP is that the technical provisions of cross border schemes must be fully funded at all times.The Government has interpreted this requirement to mean that schemes must meet the statutory funding objective (i.e. the target funding level set in accordance with the funding regime under the Pensions Act 2004). This is a key requirement, and it means that in practice most UK employers do not want their DB schemes to be cross border schemes.

Because cross border schemes are required to be fully funded at all times, they must obtain annual valuations. Where the valuation for a cross border scheme shows that the scheme is underfunded, the deficit must be made up within 24 months. An existing scheme applying for authorisation to accept cross border contributions must be fully funded at the time of the application. A newly established scheme which wants to accept cross border contributions has 2 years from the date of its application for authorisation to reach full funding. For this reason cross border schemes are rare.

The effect of the UK's decision to leave the EU on UK regulations that were required by EU law is currently unclear.

The Pensions Regulator's Responsibilities with Regard to Cross-Border Schemes

TPR is responsible for:

- the approval and authorisation processes for cross border schemes operating in the UK;
- ensuring that cross border schemes comply with the scheme funding requirements; and
- using additional supervisory powers relating to the revocation of approval and powers relating to the ring-fencing of assets.

Authorisation and Approval

A UK scheme that is operating cross border requires authorisation and approval from TPR to accept contributions on a cross border basis.

5.3.4 Insured and Self Administered Pensions

Insured Pensions

An insured pension scheme is a scheme where benefits are provided by an insurance company under an insurance policy to which premiums are paid. If the avoidance of risk (both as to mortality and investment) is the overriding concern, provided that the insurance company is selected with care, these risks can be reduced by taking out a suitable insurance policy.

In the case of a scheme with a large number of members, the insurance contract may be no more than an investment vehicle chosen by the trustees for all or part of the assets of the trust fund. By contrast, in the case of a scheme with few members, individual insurance contracts may be taken out for each member of the scheme. In either case the insurance policy is issued by the insurance company to the trustees as the policyholder and the benefits provided by the policy are accordingly payable to them and not to the member.

An insured arrangement benefits from the security of an insurance company, which is regulated under the Financial Services and Markets Act 2000, standing behind it. There is also the protection available under the Financial Services Compensation Scheme if the insurance company goes into insolvency. However, the additional security comes at a price, because of the premium that will be payable in respect of the policy and the fact that the return on assets tends to be less than could be obtained from other investment vehicles.

Examples of insured pension schemes include both DB and DC retirement benefit schemes, Stakeholder pensions and GPP plans.

The policy would be established to accept employer and/or employee contributions, either on a regular or single premium basis.

Those contributions would then be invested into one or more of the funds offered by the particular insurance company. Such funds can either be those administered and managed by the insurance company itself or, increasingly these days, 'external fund links' may be offered, allowing contributions to be invested into funds that are managed by other investment managers.

Insured schemes can be either 'bundled' or 'unbundled'.

A bundled product is one in which all the contract, including the charge structure, covers all main components associated with the arrangement, principally:

- Investment management;
- Trustee services, including administration and communication;
- Insurance services

Personal Pensions are examples of bundled products (arguably excluding SIPPs).

Where an insured scheme is unbundled, the different components are charged for separately or even provided by different organisations.

Self Administered Pensions

The term does not relate to the manner to which the scheme is administered. It relates to the way in which scheme assets are invested and generally means that instead of arranging the investment, administration and other services with one provider, usually an insurance company, the trustees seek separate organisations to provide fund management and administration services.

Self administered pension schemes, therefore, tend to be those occupational pension schemes that are of a size to warrant more control by the trustees over the ways and methods by which assets are invested. The scheme trustees are able to monitor investment performance on an ongoing basis and make changes to the managers of their investments in the light of poor performance.

5.3.5 Small Self Administered Schemes and other Executive Arrangements

A Small Self Administered Scheme (SSAS) is a trust-based occupational scheme set up for a small number of employees, typically the owner-directors of a company, and selected key staff.

Because the members are able to 'direct' investments, HMRC are concerned that the tax reliefs available to the pension scheme might be abused. In particular, members could acquire assets through a SSAS and then use those assets personally (for example a house or holiday home, or a work of art). Because of this, SSASs and other schemes where members can direct investments such as SIPPs are classified as 'investment regulated pension schemes' and subject to special tax rules.

Prior to 6 April 2006, it was a requirement that all SSASs had an appropriately experienced professional trustee selected from an approved list of 'pensioneer trustees'. Although this is no longer a requirement, the scheme documentation might still refer to a pensioneer trustee.

As well as SSASs and SIPPS, the other arrangements commonly used for senior company personnel are executive schemes and top up schemes.

Executive schemes (historically sometimes known as 'top hat' schemes) are schemes which typically offer a higher level of benefits than is provided for the majority of the company's employees; alternatively, it might provide benefits of a different type – for example the executives might receive final salary benefits and the staff average salary or money purchase benefits. Having completely separate schemes is sometimes preferred to the alternative of providing benefits for the staff and executive in different arrangements but within the same scheme.

A top up, or supplementary, scheme is one that sits alongside the main scheme. The executive will have be entitled to benefits from the main scheme at the same level as staff members, but these will be topped up to some higher amount by the supplementary scheme. When the executive retires, the benefits will often be aggregated and paid from one scheme only (a transfer payment being made between the two schemes).

Executives may also have retained benefits in legacy arrangements relating to previous periods of their careers during which they were self-employed (including as partners in a partnership). Often such benefits will be provided by personal pensions or their predecessors, retirement annuity policies (sometimes known as 's226 policies').

Where the executive's desired retirement benefits exceed the thresholds for what can be provided through a registered scheme, to benefit from the tax advantages of a registered scheme, the company may provide additional benefits from an employer-financed retirement benefits scheme ('EFRBS'. previously known as 'unapproved schemes'). EFRBS are covered in Chapter 5.3.6 below.

5.3.6 Employer Financed Retirement Benefit Schemes (Formerly Unapproved Schemes)

Employer Financed Retirement Benefit Schemes (EFRBS)

Before the current pensions regime was introduced on 6 April 2006 there were limits on the maximum benefits that could be paid out from an 'approved' pension scheme, based on an employee's earnings. Employers who wanted to provide more than this, typically for their high earning executives, often did so by way of a top up to an 'unapproved scheme'. Such schemes which could be funded schemes with an associated trust (Funded Unapproved Retirement Benefit Schemes) or simply contractual promises made by the employer on an unfunded basis (Unfunded Unapproved Retirement Benefit Schemes). With effect from 6 April 2006, the concept of scheme 'approval' fell away, and both FURBS and UURBS became known as Employer Financed Retirement Benefit Schemes – EFRBS (which is the term used here).

The tax and NI advantages of EFRBS have been steadily eroded by successive legislative changes, most notably Finance Act 2006 and Finance Act 2011. Initially, where benefits were paid out in lump sum form, they were free of Income Tax. Contributions were normally only paid by the employer, and these were taxed on the member as a benefit in kind with the employer claiming immediate relief from Corporation Tax. Investment returns were taxed at a lower rate than other trusts. If the scheme was set up off-shore, they were not subject to UK tax except on UK-source income (although a legislative change in 1993 effectively removed the tax exemption on benefits for any new offshore Funded EFRBS).

Furthermore, the need for EFRBS reduced with the introduction of the April 2006 tax regime.The reason was that this regime removed the strict limit that applied previously on the benefits that could be paid out from an approved pension scheme. In the current regime, benefits above the member's Lifetime Allowance can to be paid, but subject to a Lifetime Allowance charge.The effect of this is to make the tax treatment of provision of benefits in a registered scheme in excess of the Lifetime Allowance broadly comparable to the tax treatment of EFRBS.

Unfunded EFRBS

In an unfunded EFRBS the employee does not suffer any tax liability on the notional cost of the benefits promised. The benefits may be paid as a pension or a lump sum and both will be taxed when they are paid to the employee in the year of receipt. Provided that no more than 25% of the value of the benefits is paid in cash form, and certain other requirements are satisfied, no National Insurance is payable on the benefits. The employer can expect to be able to treat the payments as a business expense for Corporation Tax purposes, but only at the point that the benefits are paid when the member suffers an Income Tax charge.

From April 2004 where provision through EFRBS continued, this tended to be done through unfunded arrangements because of the negative effect of the tax changes on funded arrangements (see below). The attractiveness of such arrangements from the employee's point of view could often be significantly increased by the introduction of some form of security. This would typically be triggered in the event of the employer's insolvency (or possibly change of ownership) and would result in an asset of the employer, or proceeds of an insurance policy, falling into a trust set up for the employee.

However The Finance Act 2011 introduced a clampdown on 'disguised remuneration' aimed at preventing the channelling of remuneration through third parties in order to avoid or defer income tax. While these changes usually did not affect unfunded EFRBS, they have an effect where the EFRBS is both secured and involves a third party such as an insurance company or trust. Where the disguised remuneration provisions apply, the member suffers an immediate Income Tax and National Insurance charge on the employer contributions paid. The tax due when the benefits are eventually paid is reduced by the tax already paid, and the employer can claim immediate Corporation Tax relief.

The effect is to make new secured EFRBS much less popular, although arrangements that existed on April 2011 and which are broadly unchanged since that time, may continue as they are protected from the 2011 changes.

Funded EFRBS

As mentioned above, unfunded unapproved schemes were traditionally provided for some highly paid employees but, because of the relative lack of security, some preferred to use the funded alternative.

However FA04 introduced changes which made funded EFRBS unattractive for benefit accrual or contributions after 6 April 2006. From that time, the tax on investment returns was increased to the rate applicable to other trusts.There was no longer a tax charge on employer contributions but instead the benefits paid out were taxed. These changes therefore amounted to a deferral of tax. In itself, this might have been attractive; but at the same time legislation that applied to other forms of employer benefit trust and which deferred Corporation Tax relief until the time benefits were paid out was extended to EFRBS. The term of such a deferral could be many years. Furthermore, when the relief was eventually given, it was calculated with reference to the amount of the contributions paid in rather than to the value of the benefits paid out. Because of these changes, it was uncommon for contributions to a funded EFRBS to continue after 5 April 2006.Typically other benefits were given instead, such as cash or by higher contributions to a registered scheme (in contrast to the position prior to 6 April 2006, it became possible to provide benefits in a mainstream pension scheme in excess of the tax-privileged limits)

The introduction of a 50% top rate of income tax, together with a reducing Corporation Tax rate, might have made the tax deferral characteristic of EFRBS more appealing if it were not for the disguised remuneration provisions introduced at around the same time (see above). Where the disguised remuneration charge applies, the overall effect is to make the taxation of EFRBS no more attractive than the more flexible cash alternative.

For the reasons outlined above, it is uncommon for contributions to continue to be made to Funded EFRBS. However, although some have been wound up, others continue to exist in a paid up form, since the funds that have arisen from contributions made before 6 April 2006 still enjoy certain Income Tax and Inheritance Tax advantages when they come to be paid out.

5.3.7 Investment-Regulated Pension Schemes and SIPPs

Investment-regulated pension schemes

An investment-regulated pension scheme is a scheme:

- where at least one of the members (or someone connected to him) is able to influence how his own pension pot is invested; or
- which is an occupational pension scheme with fewer than 50 members and at least one of the members (or someone connected to him) is able to influence what the pension scheme invests in.

An unauthorised payment will occur if the scheme invests either directly or indirectly in "taxable property"; this includes residential property. The restrictions are designed to prevent pension schemes being used as a tax-efficient vehicle for investment instead of for retirement saving.

Before the current tax regime was introduced on 6 April 2006 ("A-Day") a small self-administered scheme (SSAS) was a type of occupational pension scheme which met certain requirements, including not investing in insurance policies and having less than twelve members, with at least one member being connected with another member, with the employer or with a trustee of the scheme. Because the same individuals were invariably the members, the trustees, and the directors and shareholders of the employing company, special tax provisions applied to SSASs prior to A-Day. However, since A-Day SSASs have been subject to essentially the same tax and investment regime as all other registered pension schemes.

Self Invested Personal Pensions (SIPPs)

This is a personal pension plan (see 4.2.3 above) that allows a member to select the scheme's investments. SIPPs are particularly attractive to those who want more control over their investments. They give the opportunity to invest in a wide range of investments in addition to insurance products, including some property (but as investment-regulated pension schemes they are subject to the "taxable property" rules outlined above. Contributions to a SIPP count towards an individual's Annual and Lifetime Allowances.

We consider SIPPs in more detail in the Retail Advice and Regulation module.

Summary

The most common benefit structures found in occupational pension schemes are DB (including final salary and CARE schemes) and DC or 'money purchase'. In the former, the amount of pension which the member receives is directly related to pay. In the latter, the amount of pension reflects the contributions made to the scheme in respect of him and the investment return on those contributions. The most important difference between the two types of schemes is how they are funded and what this means for the burden of risk between the employer and the member.

Also provided are cash balance and hybrid schemes. Other options are being considered under the Defined Ambition umbrella. All of these can be insured or self administered. Some schemes in the public sector are unfunded, and operate on the 'pay as you go' basis.There are many different design features to be considered when establishing a pension scheme. Companies often use separate arrangements to provide some of all of the retirement benefits for their top executives.

A personal pension scheme is a pension scheme which is not an occupational pension scheme and which is established by a person with permission under the Financial Services and Markets Act 2000 to establish such a scheme. In practice, this means that personal pension schemes tend to be provided by insurance companies. Personal pension schemes provide benefits on a DC basis. Stakeholder pensions (generally a form of personal pension arrangements which met certain minimum requirements) were abolished for new members from 1 October 2012.

Employers have historically used funded and unfunded EFRBS (formerly known as funded and unfunded unapproved retirement benefit schemes) to provide pension benefits in excess of previous Revenue limits to senior employees. However, since A-Day these types of arrangement are becoming less popular.

Public sector schemes are normally set up by statute and they cover the employees of central Government, local authorities and various public bodies, including employees of the health service, teachers and the police.

In an insured scheme, the sole investment medium is an insurance policy.

A cross border scheme is a scheme that is designed to allow cross border activity. Such a scheme must be authorised by TPR and it must be fully funded at all times.

Self Test Questions

- What is meant by the term DB scheme?
- What is met by the term DC scheme?
- Outline the main reasons why employers have historically established funded and unfunded EFRBS.
- Explain what is meant by a "cross border scheme".
- Outline the conditions that a cross border scheme is required to meet.
- Outline the steps employers should consider taking in preparation for their Automatic Enrolment staging date.
- What is the difference between a final salary scheme and a CARE scheme?
- How might a scheme contain both DB and DC elements.
- Explain the principal risks present in DB and DC pension schemes and explain how these affect the employer and the members.
- How do insured and self administered schemes differ?
- Outline the main features of a public sector scheme.
- When designing a private sector scheme, what are the main design features that need to be considered?
- What are the different ways in which a company might typically provide retirement benefits for its top executives?

INTRODUCTION

As the previous Chapter demonstrates, there are a number of different options available for providing workplace pensions. A range of factors will influence the employer's choice of pension scheme, including their budget and their aims in offering the scheme to its employees.

After reading this Chapter, the student should be able to identify the advantages and disadvantages of the different options for providing workplace pensions. It is important that anyone involved with workplace pension schemes, particularly an adviser who is assisting a corporate client, understands why an employer might choose one option for providing workplace pensions over another.

6.1 COSTS

With the exception of the largest schemes, trust-based schemes often involve a higher level of cost for the employer due to the need for the employer to fund not only the costs of establishing the scheme, but also the scheme's ongoing running costs such as administration and professional adviser costs.

Contract based schemes in contrast are often cheaper for smaller employers. The establishment costs are low as they can be bought "off the shelf" and, as the provider handles much of the administration, spreading the cost over all the employers participating in the arrangement, the ongoing running costs for any particular employers is contained. However additional costs may be incurred in relation to any voluntary governance arrangements that the employer may wish to put in place and any pensions-related employee communications that the employer chooses to make. Automatic Enrolment also has specific requirements which impact on payroll design and operation.

Master trusts are able to offer lower costs for employers than most trust-based schemes as they likewise benefit from economies of scale and are able to spread fixed costs over a large client base.

6.1.1 Employer Contributions

In a DB scheme the employer's contribution rate is variable and is determined by an actuary on a periodic basis.

Unless the scheme is being used for Automatic Enrolment, an employer is not required to contribute to a DC pension scheme. Many employers do however contribute to the workplace scheme that they have made available to their employees. Employer Contributions are usually expressed as a percentage of the employee's salary. Some employers will offer a fixed contribution level, regardless of the extent to which the employee contributes to the scheme, while others will match the employee's chosen contribution rate up to a ceiling. Contribution structures that increase the employer contribution level according to the employee's seniority or length of service are also popular, but care must be taken to comply with age discrimination legislation.

Employer contributions therefore are dependent on the benefit basis and not determined by whether a trust, master trust or contract-based scheme is used.

6.1.2 Short Service Refunds

Historically, trust-based schemes have been able to offer short service refunds to members who leave the scheme with less than two years' service. A short service refund does not include employer contributions which are retained in the scheme and, although not capable of refund to the employer, can be used to pay scheme expenses. Contract-based schemes are not permitted to offer short service refunds, although there is a short 'cooling off' period in which an individual joining a contact-based arrangement can change his mind and receive a refund of any contributions made. However, short service refunds from trust-based schemes for members with more than 30 days' service has been abolished for new entrants from 1 October 2015, thus bringing trust and contract-based schemes broadly into line.

6.2 EMPLOYER CONTROL AND FLEXIBILITY

With some exceptions, such as master trusts and other trust-based schemes set up non-associated employers operating in specific industries, trust-based schemes offer an employer a far greater degree of control over scheme design and administration than contract based schemes.

An employer can design an entirely bespoke trust-based scheme at the point of establishment and, as employer consent will usually be required for scheme amendments, can exercise a degree of control over the subsequent development of the scheme. The employer is also usually able to appoint some of the scheme's trustees. With a contract-based scheme, however, the employer's control is limited to the contribution level and the range of investment options. Beyond that, the employer is required to effectively take the scheme as offered by the provider.

Changes can be made to the operational aspects of a trust-based scheme if these are considered necessary in future – for example, if a service provider does not provide the requisite level of services or investment or retirement options prove not to meet member needs. If the employer does not like changes that the provider makes to a contract-based scheme, for example in terms of the investment funds or the retirement options on offer, or feels that the scheme is being poorly administered, the only option is to move to a new scheme with an alternative provider. This is unlikely to be an attractive option for a number of reasons, not least the employee communications exercise that would be involved, and the fact that employees could be left with two pots relating to the same employment in different pension schemes, unless transfers are considered and that would involve advice costs.

Trust-based schemes can be designed to include automatic provision for dependants in the event of the member's death. Contract-based schemes usually require members to exercise an option to provide for dependants.

6.3 ADMINISTRATIVE BURDEN

Trust based schemes carry a higher administrative burden than contract-based schemes. The scheme will need to be designed and established and that involves legal costs. Then the scheme needs to be administered on an ongoing basis in a way which complies with the significant regulatory burden to which trustees are subject. This will require adviser and other service provider support and, although trustees can delegate many of their responsibilities, they must still ensure that they select appropriate advisers/service providers and monitor their performance. Most, if not all, of the trustees will be lay trustees who will not have the time or experience to be involved in scheme business on a day to day basis, and the employer will therefore need to provide administrative support to the trustees.

Contract-based schemes are largely "off the shelf " products involving limited set-up work, and the administration is carried out entirely by the scheme provider who will require little, if any, involvement from the employer beyond the deduction and payment of contributions and the provision of employee information.

6.4 RISK

Trust-based schemes are perceived as being higher risk due to the higher administrative burden and the legal requirements to which trustees are subject, particularly in relation to the management of investments. As trust-based schemes are effectively "employer branded", any member dissatisfaction with the scheme could also have a negative impact on the employer's relationship with its employees and on its reputation more generally. Failure on the part of the trustees to properly administer the scheme can, in some circumstances, lead to personal liability for the trustees.

Contract-based schemes carry a very limited administrative burden for the employer. Administration failures and poor investment performance are more likely to be associated by employees with the provider than with the employer (although this may not be the case if the employer has taken a more active role in overseeing the scheme and employees therefore perceive it as being actively engaged with the scheme). It will generally be the provider who is liable for any administration failures.

6.5 RETIREMENT OPTIONS

A trust-based scheme is unlikely to offer the full range of retirement options to members as, unless it is a very large scheme, it is unlikely to be cost effective for the scheme to do so. To access an option not provided by the scheme, members will need to obtain advice to transfer to another scheme providing that option. A contract-based scheme however is far more likely to offer the full range of retirement options given the greater economies of scale that such schemes enjoy.

6.6 EMPLOYEE PERCEPTIONS

A trust-based scheme is often perceived by employees, particularly those who have previous experience of trust-based scheme membership, as being part of the employer's operations and therefore under closer employer supervision than a contract-based scheme. The fiduciary nature of the duties owed by pension trustees also provides reassurance to employees that the scheme is well-managed.

In contrast, the fact that contract-based schemes are operated by insurance companies for the purposes of a profit-making business can lead some employees to feel that their best interests are not central to the scheme.

6.7 TAX RELIEF FOR LOW EARNERS

As explained at 4.2.2 above, contract based schemes such as GPPs operate on a relief at source method of tax of tax relief, whereas almost all trust-based schemes (with the notable exception of NEST) operates on a net pay basis. While the two methods usually give the same ultimate result, there is a difference for some low-earners (principally part time workers) whose earnings are below the tax-free allowance and who consequently do not pay tax.

Such employees do not benefit from 'tax relief' on their contributions to a net pay scheme (there is no advantage of pension contributions being deducted from pre-tax pay if no tax is being paid). However where relief at source is being used, the provider can reclaim basic rate tax on contributions of up £2,880 (assuming a 20% basic rate tax rate) even where no tax has been paid. This means that non-tax payers benefit as if they were receiving tax relief on contributions up to £3,600.

In the past, this has been more of a theoretical anomaly as very few pension scheme members would be earning less than the tax-free threshold. However, in recent years, the threshold has increased so that it is now significantly higher than the Automatic Enrolment earnings trigger (see Part 3). For some employers therefore, this might be a factor worth taking into account when deciding what scheme to use for Automatic Enrolment.

Summary

The type of workplace pension scheme (i.e. whether it is trust-based or contract based) will affect the governance arrangements that will be required for that scheme – both in terms of what the specific governance requirements are and in terms of who is responsible for ensuring that those requirements are complied with.

There are a range of advantages and disadvantages to both trust-based and contract based workplace schemes. Whether trust-based or contract based, there are a range of advantages and disadvantages. An employer's decision as to which type of scheme to offer its employees will depend on which factors are most important to it.

Relevant factors will include the relative costs of the scheme, the degree of employer control, the level of flexibility offered by the scheme, the administrative burden associated with the scheme, the level of risk created by the scheme, the retirement options offered by the scheme, the employer's previous experience (if any) of pension provision, and likely employee perceptions of the scheme.

Self Test Questions

- Identify the factors that are likely to influence an employer in deciding whether to choose a trust-based or contract-based workplace pension scheme.
- Compare the employer costs involved in operating a trust-based workplace pension scheme with those involved in operating a contract-based workplace pension scheme.
- How does the level of employer control and flexibility vary between a trust-based and a contract-based workplace pension scheme?
- How does the administrative burden differ between a trust-based workplace pension scheme and a contract-based workplace pension scheme?
- Compare the main risks associated with trust-based workplace pension schemes with those associated with contract-based workplace pension schemes.
- Discuss why employees might prefer their employer to offer a trust-based workplace pension scheme rather than a contract-based workplace pension scheme.

INTRODUCTION

In this Chapter we set out the tax rules as they apply to private, or. non State, pensions.We cover the tax relief that is given in respect of contributions made to pension schemes, and the tax payable when the benefits are paid out or 'crystallised'.Anyone who is advising members on their options needs to understand how these rules apply.Those who are considering scheme design issues or who are advising members on their options also need to understand how these rules apply.

7.1 CURRENT PENSIONS TAX REGIME

On 6 April 2006 (commonly referred to as 'A-Day'), a new pensions tax regime came into force. This represented an attempt to simplify pensions provision. One of the changes was the introduction of 'registration'. Registered schemes are granted tax concessions by Statute. The introduction of 'registration' meant that the discretion that HMRC had, before 6 April 2006, to decide whether or not schemes that satisfied the relevant criteria were given advantageous tax status, had gone. (You will learn more about HMRC's former discretionary powers in Chapter 8.)

The supervisory role of HMRC has therefore largely become that of policing the rules that are set out in legislation and issuing guidance as to how these rules are operated.

The criteria that a scheme needed to satisfy to become registered are not dissimilar from those that applied before April 2006 to maintain 'approved' status. At the changeover date, all schemes already approved as at 5 April 2006 automatically became 'registered pension schemes'. Trustees could, in theory, elect to have their schemes treated as unregistered but, as this would mean renouncing the tax benefits, it rarely happened in practice.

7.1.1 The Advantages of Registration

The advantages of registration are:

- Employer contributions to a registered scheme generally receive relief against Corporation Tax so long as the company's tax inspector is satisfied that they are incurred wholly and exclusively for the purpose of the company's business. In most cases this is a simple test to pass.
- Member contributions usually also receive relief against Income Tax.
- The scheme's investment returns are largely free of income and Capital Gains Tax. However since UK dividend income is paid out of a company's taxed profits, to the extent that a pension scheme invests in UK equities there is no advantage to this tax exemption. This is in contrast to the position prior to the abolition of Advance Corporation Tax, in 1997, when pension schemes were able to claim tax credits on the dividends.
- Members can take a part – normally one quarter – of their benefits in the form of a tax-free cash sum. From 6 April 2015 the entire non-DB benefit can be taken as an Uncrystallised Funds Pension Lump Sum (with the first 25% tax free and the remainder taxed as income).
- If the scheme is appropriately constituted, funds remaining on the death of a member before age 75 can generally be passed on as a tax free lump sum. Where a member dies over age 75 then there will generally be a tax charge at the recipients' marginal Income Tax rate% on any lump sums paid. The payment of lump sum benefits on death under age 75 is also usually free of Inheritance Tax if they are paid under discretionary trust. An appropriately constituted scheme would be a SIPP which we consider in Retail Advice and Regulation.

7.1.2 The Regulation of Registered Schemes

Contributors to, and beneficiaries of, registered schemes benefit from these tax advantages to the extent that the relevant legislation and the rules of their scheme permit. The relevant legislation is set out in the Finance Acts, principally the Finance Act 2004 (as amended by subsequent Finance Acts and by the Taxation of Pensions Act 2014), and by secondary legislation passed under those Acts.

HMRC provides online guidance on the operation of the legislation in the Pensions Tax Manual (PTM), published at **http://www.hmrc.gov.uk/manuals/ptmanual/index.htm**. The PTM was first published in December 2015 and is frequently updated. The PTM replaces the Registered Pension Schemes Manual (RPSM): the latter was issued in April 2006.

The Finance Act 2004 and the PTM only concern the conditions that need to be satisfied for certain tax reliefs to be given and the extent of those tax reliefs. There are also other, non-tax related, legislative requirements that affect pension schemes. These provisions, for example regulations made by the DWP or rules made by the Financial Conduct Authority, are not covered in the Finance Acts or in the PTM. There are also provisions in each pension scheme's rules or policy documentation, which need to be followed.

7.1.3 Conditions for Registration

For a pension scheme to become registered, a person must make an application to HMRC in a prescribed form, giving certain information and declarations. To be registered, the pension scheme must be set up by one of the following:

- an employer (or group of employers);
- established by a person who has permission to do so in accordance with the Financial Services and Markets Act 2000 (this may include insurance companies, banks, etc.); or
- Government Department or UK or Parliamentary body.

HMRC is required to grant registration unless:

- the application, other material provided to HMRC or accompanying declarations are false or materially inaccurate;
- the Scheme Administrator has failed to comply with an information notice in connection with the application, or deliberately obstructed HMRC in the course of an authorised inspection carried out in connection with the application;
- the pension scheme has not been established, or is not being maintained, wholly or mainly for the purpose of making authorised payments; or
- (from 1 September 2014) the Scheme Administrator (or any of the persons who are the Scheme Administrator) is not 'fit and proper' to be the Scheme Administrator.

HMRC originally intended the process of registration to be as simple as possible for new schemes and put together a standard application form to ensure consistency and efficient processing of the applications. However, following concerns about 'pensions liberation' (see 10.7 below), HMRC revised its procedures relating to the registration of schemes, moving away from a 'process now, check later' approach. As a result, scheme registration is no longer confirmed on successful submission of the online form. HMRC states that this will enable them to conduct detailed risk assessment activity before making a decision on whether or not to register a scheme.

7.2 THE SCHEME ADMINISTRATOR

All registered pension schemes are required to have a 'Scheme Administrator'. For this purpose, 'Scheme Administrator' is a defined term under the Finance Act 2004. It does not necessarily mean the person or body that deals with the administration of the scheme (i.e. the collection and allocation of contributions, correspondence with members, the monthly payment of pensions etc.). For the avoidance of doubt, in the remainder of this Study Manual we refer to the statutory office holder using the term 'Scheme Administrator' in Title Case (although this convention will not necessarily be followed outside this Study Manual).

A Scheme Administrator must be a 'fit and proper person' and be resident in the UK or in another EU member State (or in a handful of EEA States which are not EU member States).They must make various declarations to HMRC – in particular that the scheme meets all of the conditions to be a registered pension scheme and that the Scheme Administrator understands all of the liabilities which he is taking on.

More than one person may be appointed as Scheme Administrator and, in this case, each is jointly and severally liable for any tax charges or penalties for which the Scheme Administrator is liable.

A Scheme Administrator is often a trustee but may be a person or corporate body appointed by the trustees. Unless the Scheme Administrator is a corporate body, it must be a named individual or group of such persons.

The Scheme Administrator must be registered with HMRC. Application for registration as a Scheme Administrator and for the registration of the scheme itself for new schemes set up after 5 April 2006 is completed online, as is nearly all communication with HMRC. The Scheme Administrator can authorise HMRC to deal with one or more scheme practitioners.

The main duties of the Scheme Administrator are:

- record keeping, including: monies received. paid and owing; details of assets, members' benefits
- providing information to members (and dependants where appropriate), HMRC and other parties such as other schemes or adviser (provided the member has authorised the release of this information)

7.3 LIFETIME ALLOWANCE

One of the key elements of the tax regime is the Lifetime Allowance. Broadly speaking, this is an allowance of the total pension rights, which an individual may accrue in their life while still enjoying a tax favoured environment. The Lifetime Allowance was introduced on 6 April 2006 at the level of £1.5 million and has changed each subsequent year as shown in the table below.

Tax Year	Standard Lifetime Allowance
2006/07	£ 1,500,000
2007/08	£ 1,600,000
2008/09	£ 1,650,000
2009/10	£ 1,750,000
2010/11	£ 1,800,000
2011/12	£ 1,800,000
2012/13	£ 1,500,000
2013/14	£ 1,500,000
2014/15	£ 1,250,000
2015/16	£ 1,250,000
2016/17	£ 1,000,000
2017/18	£ 1,000,000
2018/19	£ 1,000,000
2019/20	£1,055,000

Under transitional arrangements, some individuals were able to file for 'protection' against the Lifetime Allowance Charge, in which case different rules apply.

The Finance Act 2011 reduced the Lifetime Allowance in 2012/13 and subsequent years to £1.5m. Individuals could elect to continue to be subject to the higher £1.8m limit previously in place (so called 'fixed protection') but only if they ceased active membership of all registered schemes before 6 April 2012.

The Finance Act 2013 reduced the Lifetime Allowance further, from £1.5m to £1.25m with effect from 2014/15 and later years. Alongside this reduction, further forms of 'protection' for members with large pension rights were introduced by the Finance Acts of 2013 and 2014. A further reduction to £1m from the tax year 2016/2017 was announced in the 2015 Budget, with index-linking to be introduced from April 2018. Additional protections (individual protection 2016 and fixed protection 2016) were introduced in the Finance Act 2016, with retrospective effect to 6 April 2016.The following table summarises the transitional protections available.

Protection	What it covers	Formalities	Future accrual?
Primary	Savings >£1.5m at 5 April 2006.	Notify HMRC by 5 April 2009.	Y
Enhanced	Fully protects rights accrued as at 5 April 2006.	Notify HMRC by 5 April 2009 and no accrual from 6 April 2006.	N
Fixed	Fixes LA at £1.8m (or SLA if higher).	Apply to HMRC by 5 April 2012. Not needed for those with primary or enhanced protection.	N
Fixed 2014 (FP14)	Fixes LA at £1.5m (or SLA if higher).	Apply to HMRC by 5 April 2014. Not needed for those with primary, enhanced or fixed protection.	N
Individual 2014 (IP14)	Savings >£1.25m at 5 April 2014. Fixes LA as value of pension rights at 5 April 2014 (max £1.5m) or SLA if higher.	Apply to HMRC by 5 April 2017. Not available to those with primary protection.	Y
Fixed 2016 (FP16)	Fixes LA at £1.25m (or SLA if higher).	Apply online to HMRC from July 2016. Not available to those with primary, enhanced or fixed protection or FP14.	N
Individual 2016 (IP16)	Savings >£1m at 5 April 2016. Fixes LA as value of pension rights at 5 April 2016 (max £1.25m) or SLA if higher.	Apply online to HMRC from July 2016. Not available to those with primary protection or IP16.	Y

The general rule is that whenever a member takes benefits from a registered pension scheme, and on certain other occasions (so called Benefit Crystallisation Events – see 7.3.1 below), part of their Lifetime Allowance is used up.When there is no longer any Lifetime Allowance remaining, any further benefits put into payment will attract an additional tax called the Lifetime Allowance Charge.

The Lifetime Allowance Charge is set at a level that is intended to remove the tax advantages that the person has previously received in relation to those benefits because of their membership of a registered pension scheme. The overall effect is that benefits with a total value up to the Lifetime Allowance will enjoy the tax advantages of a registered pension scheme, but the taxation of any benefits above this level is intended to be broadly neutral.

The level of the Lifetime Allowance Charge depends on whether the benefits subject to the charge are taken in pension or lump sum form.

7.3.1 Benefit Crystallisation Events (BCEs)

A BCE is an event in a registered scheme which triggers a test of the member's benefits against the Lifetime Allowance. There are 13 BCEs. These are:

BCE1	Assets being put into 'drawdown' or 'income withdrawal'
BCE2	A scheme pension coming into payment.
BCE3	An increase to a pension in payment exceeding certain permitted annual indexation levels (broadly, the greater of 5% and the increase in the RPI).
BCE4	Using the assets of a money purchase scheme to buy a 'lifetime annuity' for a member from an insurance company.
BCE5	A member of a defined benefit arrangement reaching age 75 without having put a scheme pension into payment.
BCE5A	A member of a money purchase arrangement reaching age 75 with funds still in drawdown.
BCE5B	A member of a money purchase arrangement reaching age 75 with funds that have not been put into drawdown and which have not been used to buy an annuity / scheme pension.
BCE5C	On or after 6 April 2015, uncrystallised funds are designated for drawdown by a dependent or nominee.
BCE5D	On or after 6 April 2015, a dependent or nominee becoming entitled to an annuity purchased using uncrystallised funds.
BCE6	The payment of a Pension Commencement Lump Sum, Uncrystallised Funds Pension Lump Sum or certain other lump sums.
BCE7	Payment of most lump sum benefits on the death of a member.
BCE8	The transfer of pension rights to a Recognised Overseas Pension Scheme.
BCE9	Miscellaneous events as set out in regulations, principally certain lump sum payments which do not fall under BCE6 for technical reasons.

Each time a test is made, part of the person's Lifetime Allowance is deemed to be used up. If there is insufficient Lifetime Allowance remaining at the time of the test, then a Lifetime Allowance charge will become payable.

7.3.2 Valuing Pension Rights

To determine whether a person's total pension rights exceed the Lifetime Allowance, they need to be valued. HMRC has laid down a set of criteria for making such a valuation when pension rights are crystallised:

- for a money purchase scheme, the value of the pension rights is taken as the fund value at the time of crystallisation.
- for a DB scheme, the value is the amount of any cash sum taken plus 20 x the starting pension.

If a person is receiving a pension that was put into payment prior to 6 April 2006 (i.e. under the previous tax regime) then this is also tested. Such 'pre-commencement pensions' are tested at the time of the first post 6 April 2006 Benefit Crystallisation Event. The value of the pension is then deducted from the member's Lifetime Allowance. For this purpose, pre-commencement pensions are valued by multiplying the pension in payment at the time of the first Benefit Crystallisation Event by 25.

7.4 ANNUAL ALLOWANCE

Another key element of the current regime is the Annual Allowance. Before April 2006, there were no rules on how much benefit could accrue during the year (provided the overall benefit maxima were not exceeded with the addition of that year's accruals), but there were complex rules governing the maximum contributions that could be paid in. The Annual Allowance completely replaced all these rules.

The Annual Allowance is an upper threshold for the amount of new pension benefit that a member can accrue each year before being subject to a tax charge. For DB schemes, the value of any pension accrued during the year is tested against this limit. For DC schemes, it is the total contribution paid that is tested. If the value of the new pension benefit in any year exceeds the Annual Allowance, then the member is subject to a tax charge on the excess.

The amount that is tested against the Annual Allowance in any year is called the 'pension input amount'. The period over which the Annual Allowance is assessed is called 'the Pension Input Period' (PIP). From 6 April 2016 all PIPs are aligned with the tax year. Prior to that they did not necessarily have to be aligned with the tax year and careful tax planning enabled PIPs to be manipulated to a limited extent to maximise contribution input. Since someone might be a member of more than one pension scheme or arrangement, it was possible for there to be more than one PIP. In this case, in each tax year the total pension input amounts paid in all the PIPs ending in that tax year were aggregated and measured against the Annual Allowance for the year. Transitional provisions were put in place for in tax year 2015/16 to achieve the alignment. Essentially 2015/16 was split into two mini tax years with a single Annual Allowance charge for tax year 2015/16 as a whole arising if an individual exceeded the aggregate Annual Allowance for the mini tax years.

The initial level of the Annual Allowance was £215,000, but it changes, as shown in table below:

Tax Year	Annual Allowance
2006/07	£ 215,000
2007/08	£ 225,000
2008/09	£ 235,000
2009/10	£ 245,000
2010/11	£ 255,000
2011/12	£ 50,000
2012/13	£ 50,000
2013/14	£ 50,000
2014/15	£ 40,000
2015/16	£ 40,000
2016/17	£ 40,000
2017/18	£ 40,000
2018/19	£ 40,000
2019/20	£40,000

The substantial cut in the Annual Allowance from 6 April 2011 was prompted by two main factors:

- the poor state of the public finances and the consequent need to raise revenue; and
- the continued fear * that the 50% additional rate of Income Tax introduced in 2010/11 would prompt high earners to put excessive amounts into pension schemes to avoid (or defer) tax.

* The Finance Act 2009 had already restricted the availability of higher rate tax relief on pension scheme contributions with effect from April 2009 to 5 April 2011 for people with a taxable income of £130,000 or more.

As well as reducing the amount of the Annual Allowance, the Finance Act 2011 made various other changes. These are the principal ones:

- The amount of the Annual Allowance Charge was originally 40%. For 2011/12 and subsequent years, the Charge is calculated by deeming the pension input amount to be part of the individual's earnings and working out the tax accordingly (so in most cases, it will be the individual's marginal rate of tax, with a more complex calculation applying where including the pension input as income would push the individual into a higher tax band).
- Before 2011/12, for any given pension arrangement, the Annual Allowance does not apply in the year in which the member starts to draw all his benefits from that arrangement. For inputs applicable to 2011/12 and subsequent years, the exemption for those who take all their benefits does not apply (except on death or in certain cases of ill health). The Annual Allowance is not granted to any member who has Enhanced Protection (see 8.2 below) or later versions of transitional protection granted when the Lifetime Allowance reduced.
- Where a chargeable amount arises in 2011/12 or subsequent years, any unused relief attributable to the previous three tax years (i.e. the difference between the pension input in those years and the relevant Annual Allowance, for this purpose taken to be £50k for the years before 2011/12) can be carried forward and used to offset any charge. The effect of this is to limit the effect of the reduced Annual Allowance on those whose pension input is normally well below the £50k limit but who may experience a 'spike' in their input due to a one-off event such as a promotion (particularly members of final salary schemes with long service), an augmentation to their benefits on retirement or redundancy or as a result of fluctuating earnings where money purchase schemes are involved.

The Finance Act 2013 reduced the Annual Allowance further, from £50k to £40k with effect from 2014/15 and later years.

Money Purchase Annual Allowance

Further restrictions on contributions have also been introduced. Individuals who flexibly access a money purchase arrangement will also have to test their total pension input amount against a 'Money Purchase Annual Allowance' (MPAA). This change is intended to prevent individuals exploiting the new flexibilities by diverting their salary into a pension scheme with tax relief and then immediately accessing money purchase benefits.

The MPAA is triggered where an individual:

- draws down funds from a flexi-access drawdown fund;
- receives an uncrystallised funds pension lump sum;
- converts a pre-April 2015 drawdown fund to a flexi-access fund and then takes drawdown;
- takes more than the permitted maximum for capped drawdown;
- receives a 'stand-alone lump sum' from a money purchase arrangement where the individual was entitled to primary protection but not to enhanced protection;
- has received a pre-6 April 2015 payment from a flexible drawdown fund; or
- has become entitled to a payment under a flexible annuity contract.

Prior to April 2017, the MPAA was £10,000. From 6 April 2017, the MPAA was reduced to £4,000.

Alternative Annual Allowance

For persons with both DB and DC benefits the Alternative Annual Allowance (AAA – sometimes referred to as just Alternative Allowance) may be used. The maximum amount of DB savings which qualify for tax relief, once the MPAA has been triggered, is (from 6 April 2017) £36,000 (plus any carry forward allowance from the previous three tax years). If DB savings exceed the AAA, a tax charge is made clawing back any tax relief given on the excess pension savings.

Tapered Annual Allowance

From 6 April 2016, a reduced Annual Allowance applies to individuals with an adjusted income in a tax year above £150,000 and a threshold income in the same tax year of more than £110,000. (This echoes the changes made in the Finance Act 2009 mentioned above -below AA table.) The Annual Allowance is reduced on a tapered basis by £1 for every £2 of income above £150,000, rounded to the nearer £1, subject to a floor of £10,000.Therefore, the Annual Allowance will generally be £10,000 for an individual with an income of over £210,000. An individual's adjusted income is the taxable income after allowing for certain reliefs plus the value of their pension savings in the tax year. An individual's threshold income is the taxable income after allowing for certain reliefs plus the value of certain pension-related salary sacrifice type arrangements.

Anti-avoidance rules for the tapered Annual Allowance apply resulting in certain arrangements, which includes an agreement, understanding, scheme, transaction or a series of transactions whether or not legally enforceable, being disregarded from the calculation. This will arise where it is reasonable to assume that at least one of the main purposes of an arrangement is to reduce the individual's adjusted and/or threshold income for the tax year.

7.4.1 Annual Allowance for Money Purchase Schemes

In a money purchase scheme, the pension input amount is the total 'relievable contribution' paid by or on behalf of the member in the Pension Input Period (PIP), together with any employer contribution paid into his pension account.

This includes any AVCs paid by the member but does not include most transfers into the scheme from other arrangements.

7.4.2 Annual Allowance for Defined Benefit or Cash Balance Schemes

The Annual Allowance operates in a different way for DB schemes. In these arrangements, the value of a person's pension rights (i.e. their accrued pension) at the end of the PIP is compared with the value of their pension rights at the beginning of the period. Subject to certain adjustments, the difference is the pension input amount for the period.

For inputs relating to 2010/11 and later tax years, for the purpose of valuing the pension benefits at the start and end of the PIP, a factor of 16 is used. A factor of 10 was used for earlier tax years.

Adjustments are made to the figures to take account of any transfers in or out of the scheme and also of any pension debits or credits resulting from a divorce.

Deferred members with benefits that are revalued at or below the increase in the CPI (or any higher rate written into the scheme rules as they stood on 14 October 2010) will be deemed as having no input.

7.4.3 The Annual Allowance and Tax Relief

An individual may pay an unlimited amount into a pension scheme in any tax year but will enjoy tax relief only up to 100% of UK taxable earnings (or £3,600 to a scheme operating on a 'relief at source basis' if this is higher).

If someone were to pay contributions that exceeded both their earnings and the Annual Allowance, then the top slice of their contributions would be subject to the Annual Allowance Charge but not receive any compensatory tax relief (unless carry forward of unused AA was available).

An employer will also be allowed to pay an unlimited amount into a pension scheme on behalf of an employee but, again, any payment above the Annual Allowance figure would render the individual liable to a tax charge.

7.4.4 'Scheme Pays'

The member is liable for any Annual Allowance Charge that may be due. However the member has the right to require the scheme to pay the charge on their behalf, provided certain conditions are satisfied.

- The member's Annual Allowance Charge liability for the tax year must exceed £2,000.
- The pension input amount under the scheme must exceed the Annual Allowance for that year.
- The member must make the request by means of an irrevocable election made in a prescribed form. The deadline for this is 31 July after the end of the following tax year (so for example the election has to be made by 31 July 2019, for an Annual Allowance Charge relating to the tax year ending 5 April 2018).

In return, the scheme will reduce the member's benefit entitlement by the amount of the Annual Allowance charge. In this case, the Scheme Administrator and the member have a joint and several liability for the charge.

Where the member has an Annual Allowance liability but one or more of the above conditions is not satisfied, the scheme can decide voluntarily to pay the member's charge on his behalf and reduce the member's benefit entitlement accordingly.

7.4.5 Disclosure Requirements

Where a member of a scheme has benefits within that scheme and the increase in those benefits exceed the Annual Allowance, the trustees or managers are required to automatically provide a 'pension savings statement' within six months from the end of the tax year. (This statement is not to be confused with the annual benefit statement a scheme sends to members). No account is taken of any unused relief carried forward or of any pension input the member has in other schemes (neither of which the trustees or manager can be expected to know about).

The pensions savings statement will show the pension input amount arising in the scheme during the PIP, together with the corresponding amounts for each of the previous three years.

Members who have not exceeded the Annual Allowance in a particular scheme can request a pensions savings statement. If they do, the pension scheme is required to provide one by the later of three months from the request and six months from the end of the tax year.

There are also disclosure requirements that apply to employers, who must provide the scheme with sufficient information to calculate the pension input amounts of its employees by 6 July following the end of the tax year.

Where a member has first accessed flexible benefits and triggered the Money Purchase Annual Allowance, the Scheme Administrator must (within 31 days of the first payment) send the individual a statement confirming this and giving details of the member's duty to report this to the Scheme Administrator of any other registered scheme under which he is accruing benefits.

7.5 AUTHORISED PAYMENTS

Prior to 6 April 2006, there were HMRC limits on the maximum benefits that occupational pension schemes could pay to members in various circumstances. Because there were stricter limits on the contributions that could be paid in, personal pensions were subject to fewer limits on the benefits being paid out.

On 6 April 2006, the previous regime was replaced by a system of authorised and unauthorised payments. Registered pension schemes are allowed to make unauthorised payments but, when they do, there are additional charges levied on the scheme and/or the beneficiary.

The Finance Act 2004 and supporting legislation prescribes certain payments which may be made without attracting tax charges over and above the normal Income Tax paid on pensions and similar taxes due in respect of certain other benefits. These are known as authorised payments.

Subject to certain conditions, the following are usually authorised member payments:

- pensions and pension death benefits;
- lump sums and lump sum death benefits;
- transfers to other registered pension arrangements
- transfers to a 'recognised overseas pension scheme' (ROPS) (particular care is needed here following amendments made in 2015 by HMRC from QROPS list to ROPS list: HMRC were concerned that "Q", for "Qualifying" gave the wrong message; at the same time HMRC significantly reduced the number of schemes on the list.This aspect is considered further in Chapter 10.);
- certain 'scheme administration' payments; and
- payments pursuant to a pension sharing order.

On 14 March 2017, the Registered Pension Schemes (Authorised Payments) (Amendment) Regulations 2017 amended the authorised payment regime to introduce a new authorised payment with effect from 6 April 2017:

- the Pension Advice Allowance.

A payment by a registered pension scheme not exceeding £500 will be authorised if the conditions set out in the regulations are met.The allowance, which can only be paid from money purchase or hybrid arrangements, may be taken up to three times by an individual. The request for the payment must be in writing and the member must declare that the advice is regulated financial advice provided by an FCA authorised financial adviser, as well as declaring that no more than two Pension Advice Allowance payments have previously been requested and made. Only one payment is allowed per tax year. The payment must be made direct from the scheme to the financial adviser.

In certain circumstances, other payments that were made in genuine error will be regarded as authorised.

All payments that are not included in the statutory list of authorised payments are 'unauthorised' and give rise to tax charges payable by the Scheme Administrator and/or the member.

7.5.1 Tax Charges on Unauthorised Payments

The making of an unauthorised payment will generate up to four tax charges:

- the Unauthorised Payments Charge – a tax charge at a rate of 40%, based on the value of the unauthorised payment;
- the Unauthorised Payments Surcharge – where 25% or more of the value of a member's benefits is paid out in the form of an unauthorised payment an additional tax charge at a rate of 15% will be due, based on the value of the unauthorised payment;
- the Scheme Sanction Charge – a tax charge on the Scheme Administrator. The scheme sanction charge is due on most unauthorised payments, the main exceptions being where the Scheme Administrator would not have known that the payment was unauthorised at the time it was made; the tax rate is normally 15% of the value of the payment, but this increases to 40% if HMRC have been unable to recover the unauthorised payments charge from the recipient;
- a Deregistration Charge (rare) – if a scheme pays out more than 25% of its assets in the form of unauthorised payments in any year then it may have its registration withdrawn. In this case a deregistration charge will be applied equal to 40% of the value of the scheme's assets.

Where a payment is subject to an unauthorised payments charge, it will not also be subject to Income Tax. However, the combination of the unauthorised payments charges and scheme sanction charges is normally sufficient for pension schemes to try to find ways of avoiding making unauthorised payments wherever possible.

7.6 TAX TREATMENT OF UNREGISTERED SCHEMES

We outline below the tax treatment of Employer Funded Retirement Benefit Schemes (EFRBS) and Qualifying Recognised Overseas Pension Schemes (QROPS).

7.6.1 Employer Funded Retirement Benefit Schemes (EFRBS)

Background

Because of the need to protect tax revenues, there have always been limits on the extent to which someone can benefit from a 'tax-privileged' pension scheme (i.e. a 'registered' or, prior to April 2006, 'approved' pension scheme). As a consequence, there has long been a demand for 'top-up' arrangements outside the mainstream pensions savings environment, particularly for high-earners.

Before April 2006, the main top-up vehicles used were 'Funded Unapproved Retirement Benefit Schemes' (FURBS) and 'Unfunded Unapproved Retirement Benefit Schemes' (UURBS).The tax treatment of FURBS was broadly:

- no tax relief on contributions on the way in;
- no tax relief on investment returns; and
- exemption from tax on benefits paid out.

This was referred to as '**T**axed, **T**axed, **E**xempt', or 'TTE'. There were certain tax and National Insurance advantages on contributions and investment returns, but these were progressively reduced over the years. UURBS were attractive to employers because of cash flow rather than taxation considerations. But from the employee's viewpoint, UURBS were often seen as unacceptably risky because of the absence of pre-funding. A compromise was the secured UURBS, a benefit promise that was unfunded but secured over some company asset, or backed by a bank guarantee.

Post-2006 tax regime

From April 2006, FURBS and UURBS became known as 'Employer Financed Retirement Benefit Schemes', or EFRBS.The taxation of funded EFRBS was changed from 'TTE' to 'ETT' (relief available on contributions paid in, but benefits ultimately paid out subject to tax).Therefore the main attraction of funded EFRBS became the deferral of Income Tax. However, Corporation Tax relief was also deferred until the benefits were paid. Because of this (and also because since April 2006 top-up benefits could be paid from within a registered scheme, albeit subject to the Lifetime Allowance charge —see 7.3 above), EFRBS became unattractive and their use after April 2006 declined sharply. However unfunded EFRBS continued to be popular, particularly where suitable security was available.

In April 2010 the top rate of Income Tax increased to 50%. At the same time, corporation tax went down, with the prospect of further reductions in the future.This made the tax deferral aspect of EFRBS attractive again. In order to prevent a revival in the popularity of these vehicles, and a resulting deferral of much-needed tax revenue, the Government took steps intended to make EFRBS no more attractive than other forms of remuneration. These took the form of 'disguised remuneration' legislation, measures that targeted all sorts of arrangements through which employment remuneration was provided via third parties, including some types of EFRBS.

'Disguised remuneration'

The disguised remuneration provisions were contained in the Finance Act 2011, which inserted a new Part 7A into the Income Tax (Earnings and Pensions) Act 2003 – ITEPA03. (The provisions therefore are sometimes known as 'Part 7A' provisions or charges.) These apply when a 'relevant third person' (meaning broadly someone other than the employer) makes provision in connection with the individual's employment.

As a result, in the case of funded EFRBS, any new contributions paid after 5 April 2011 will result in an Income Tax charge on the employee. In the case of unfunded EFRBS, any increase in security given after 5 April 2011 might result in an Income Tax charge on the employee (depending on whether or not the arrangement involves a third party).

Unfunded EFRBS, where there is no security or where there is no undertaking involving a third person, are currently unaffected by the Finance Act 2011 provisions. However, the Government has said that it will monitor changes in patterns of pension savings behaviour and act if necessary to prevent loss of tax revenue. In certain circumstances the use of an unfunded EFRBS must be reported to HMRC under the Disclosure of Tax Avoidance Schemes (DOTAS) provisions, effective from November 2013.

Where an immediate Income Tax charge is levied under the disguised remuneration provisions, in order to avoid double counting it will be offset against the tax that would otherwise be due when the benefits are ultimately paid out.

Taxation outline of EFRBS

The main features of the taxation of EFRBS are as follows:

- the member might suffer a 'disguised remuneration' or 'Part 7A' charge at the time provision for future benefits is made for him through the EFRBS (see above);
- the Lifetime Allowance and Annual Allowance do not apply in relation to an EFRBS (see 7.3 and 7.4 above);
- in funded EFRBS investment income and capital gains are subject to tax, although non-UK income may be exempt where the arrangement is set up off-shore (i.e. the trustees are not UK resident);
- lump sum and pension payments are subject to Income Tax (although subject to certain conditions relating to the age at which the benefits can be paid, and the proportion that can be taken in lump sum form, NI will not be payable); this will be offset by any Part 7A charge already incurred; and
- Corporation Tax relief is available in relation to the contributions paid by the employer, but only at the point when the member become subject to an Income Tax charge; as a result, Corporation Tax relief is received earlier in cases where the disguised remuneration charge applies than in cases when it does not.

7.62 Qualifying Recognised Overseas Pension Schemes (QROPS)

The concept of a 'Qualifying Recognised Overseas Pension Scheme (QROPS)' was introduced by the Finance Act 2004 as part of the UK's new pensions tax regime introduced by that Act with effect from 6 April 2006. Benefits in UK registered schemes were allowed substantial tax advantages in terms of tax relief on contributions paid in and on investment income. In return the scheme had to provide retirement benefits, and in the main these would be subject to Income Tax. In order to prevent these tax privileges from being abused, where a member wanted to transfer their benefit rights out of a registered pension scheme, the Act laid down rules that restrict where the transfer could be paid to. If the destination was overseas, in order to be authorised the transfer has to go to a QROPS.

As mentioned earlier, the numbers of the QROPS list have been reduced and HMRC now refer to "ROPS" having dropped "Qualifying" to try to emphasise that any transfers to such schemes involve risk and that the transferee, his adviser and the scheme trustees need to take particular care.

The principal feature of a QROPS is that the scheme manager has to give HMRC an undertaking to inform them when the scheme makes a payment out in respect of the member. This then enables HMRC to ensure that the payment is taxed accordingly. Broadly speaking, where payments are made out of funds that have originated from a UK registered scheme then the recipient will be taxed in the same way as if they had been paid direct from the UK scheme, irrespective of whether the recipient is resident or ordinarily resident in the UK at the time.The principal exception to this is where the person concerned is resident in a country that has a double taxation agreement with the UK and where the pension is taxed in the host country.

A scheme that has been accepted as a QROPS will appear on a list that is published by HMRC (provided the scheme has given its consent to this). This enables the administrator of a UK registered scheme to check the status of the receiving arrangement when a member has requested a transfer and thus avoid the possibility of a scheme sanction charge arising on account of the scheme making an unauthorised transfer. (For the treatment of unauthorised payments, see 7.5 above.)

There were concerns that the ability to transfer funds from a registered scheme to a QROPS was not always being used in a way that was consistent with the Government's policy objective. This objective was to allow individuals who intend to leave the UK permanently to take their pension savings with them, free of UK tax, to their new country of residence in order to continue saving to provide an income in their retirement.

In response to these concerns, new regulations came into force on 6 April 2012 which revised the conditions that a scheme has to meet to be a QROPS. The regulations also strengthened the information and reporting requirements with the aim of ensuring better operation of the regime and deterring misuse.The policy objective remains to ensure that the system continues to be used for its intended purpose of allowing individuals who intend to leave the UK permanently to take their pension savings with them, free of UK tax, to their new country of residence in order to continue saving to provide an income in their retirement.The regulations introduced:

- an acknowledgement by the individual, to be completed before a transfer is made, that tax charges may apply; and
- additional information requirements and revised time limits for registered pension schemes to report transfers to QROPS.

Significant changes to the QROPS system were introduced in the Finance Act 2017 which received royal assent on 27 April 2017 with retrospective application. Transfers to a QROPS requested on or after 9 March 2017 will be taxed at a rate of 25 per cent (the "overseas transfer charge") unless at least one of the following conditions apply:

- both the individual and the QROPS are in the same country after the transfer;
- the QROPS is in one EEA country and the individual is resident in another EEA country after the transfer;
- the QROPS is an occupational pension scheme sponsored by the individual's employer;
- the QROPS is an overseas public service pension scheme and the individual is employed by a participating employer; and
- the QROPS is a pension scheme established by an international organisation and the individual is employed by that organisation.

The legislation allows the tax position to be revisited during the "relevant period" (five full tax years from the date of the transfer to the QROPS).The charge will still apply to a tax-free transfer if, within the relevant period, an individual becomes resident in another country so that the exemptions would not have applied. However, the charge may be reclaimed if the member made a taxable transfer but one of the exemptions starts to apply within the relevant period.

The Scheme Administrator of the registered pension scheme making the transfer is jointly and severally liable, with the member, to the tax charge and is required to deduct it before making the transfer and pay it to HMRC. If a Scheme Administrator did not deduct tax when it should have, because it thought the transfer was not taxable, it can apply to HMRC to be discharged from liability to the overseas transfer charge (although the member remains liable). However, HMRC expects Scheme Administrators to consider critically the information provided by the member and take reasonable care in establishing the correct position before making the transfer.

Managers of any scheme that was a QROPS on 8 March 2017 had to submit a revised undertaking to HMRC by 13 April 2017, confirming that they wished the scheme to remain a QROPS and operate the overseas transfer charge. If no undertaking was received, the scheme stopped being a QROPS on 14 April 2017.

Summary

April 2006 saw a radical overhaul of the tax legislation governing pension schemes in the UK. Schemes that are registered in accordance with the current regime enjoy tax advantages, as do those who contribute to them. Each registered scheme must have a Scheme Administrator who has certain duties in relation to record keeping and provision of information.

Two prominent features of the post 2006 regime are the Lifetime Allowance and the Annual Allowance. As originally implemented, neither had any real impact on the majority of pension scheme members, being relevant principally for high earners (although a test against the Lifetime Allowance needs to be done for all members whenever a Benefit Crystallisation Event occurs). However the reduction of the Annual Allowance in particular, while mitigated by the ability to carry forward unused relief, has potentially brought many more individuals 'into the net'.

Another key feature of the current tax regime is the system of authorised and unauthorised payments. Although both are allowed, unauthorised payments suffer additional tax charges, sometimes at a punitive level.

Self Test Questions

- If a pension scheme is being set up, why might one want it to be treated as a registered scheme?
- Outline HMRC's role in relation to a registered pension scheme.
- What are the duties of a Scheme Administrator?
- How might the Lifetime Allowance impact on a member who has large pension benefits?
- An individual with no pension arrangements has received a £40,000 inheritance following the death of a relative, and is considering paying it all into a personal pension. Explain any tax considerations that should be borne in mind.
- Why, in normal circumstances, should pension schemes attempt to ensure that all the payments they make to members are 'authorised'.

INTRODUCTION

In this Chapter we look at the tax system that applied before the current regime was put in place on 6 April 2006, or 'A-Day'. An understanding of the pre-April 2006 tax regime is important for two reasons: firstly, because some of the old rules can be used under transitional arrangements where they are more beneficial to the member; secondly, the old rules set out the maximum benefits and contributions that were allowed, and these 'Inland Revenue maxima' are incorporated into many scheme rules and policy provisions. An adviser who is aware of these old rules is in a stronger position to help his client.

8.1 PRE APRIL 2006 TAX REGIME

Prior to April 2006, the legislation governing the tax treatment of pension schemes (see Chapter 1) was consolidated in Chapter I Part XIV of Income and Corporation Taxes Act 1988 as amended by later Finance Acts and supplementary Statutory Instruments.

Pension schemes that were eligible for favourable tax treatment (broadly, tax relief on the investment income, the ability prior to July1997 to reclaim tax paid on dividends, Income and Corporation Tax relief on contributions and tax-free payment of certain lump sum benefits) were known as schemes that were 'approved' by the Superannuation Funds Office (later Pension Schemes Office) of the Inland Revenue (now HMRC). The legislation set out the basic conditions, which entitled a pension scheme to automatic Inland Revenue approval. The legislation also supplemented this with discretionary powers to enable the Inland Revenue to approve schemes, which did not fully comply with these conditions necessary for automatic approval.

The vast majority of private sector schemes received 'discretionary' approval. This contrasts with the public sector, where schemes were often set up by, and are governed by, a specific Act of Parliament (for example separate Acts govern those public sector schemes established for teachers, the police and NHS workers). A few private schemes opted for automatic approval: these schemes provided a restricted level of benefits.

Discretionary Approval

When a scheme was subject to discretionary approval, it could provide only 'relevant benefits' within the ranges specified by the Inland Revenue.

'Relevant benefits' were defined under ICTA 88 (and earlier legislation) as being any type of financial benefit given by an employer on retirement or death but excluding benefits in connection with redundancy and excluding benefits on death receivable only in the event of death by accident or disablement during service.

The Inland Revenue Guidance was primarily contained in two manuals or 'Practice Notes' aimed at pensions practitioners, one relating to occupational schemes being known as IR(12) and one for personal pensions IR(76). These were regularly updated with sometimes quite bulky Joint Office Memoranda setting out new and amended rules. Nowadays, the changes are made on line to the Pensions Taxation Manual.

If schemes failed to comply with the guidance issued under the Inland Revenue's discretionary powers, the ultimate sanction was the withdrawal of approval. This would have resulted in very severe tax consequences (a tax charge of 40% of the value of the scheme's assets) but was a very rare event.

For occupational pension schemes, the main effect of the Inland Revenue guidance was to impose limits on the maximum benefits that an approved scheme could pay its beneficiaries in various circumstances. These were known as 'Inland Revenue limits' or 'Inland Revenue Maxima'. Since 6 April 2006, these limits no longer apply. However the majority of pensions schemes in existence today were set up under the old regime and consequently their rules often reflect the old Inland Revenue limits. These limits are outlined in the box below.

PRE APRIL 2006 INLAND REVENUE RULES

The candidate is not expected to learn all the detail of the Inland Revenue limits that applied before 6 April 2006. However, an understanding of the basic structure is required, as the limits are still referred to and the design of many schemes is based upon them. An outline of the pre 6 April 2006 limits is as follows:

1. Personal Pensions (including Stakeholder Pensions and SIPPs) and Retirement Annuities ('Section 226 Policies')

There was no limit to the total benefits emerging, but there was a limit on the contributions that could be paid in.The contribution limit was expressed as a percentage of earnings and depended on the age of the contributor. Apart from Retirement Annuities, the earnings on which contributions were based were limited to an 'Earnings Cap', often referred to as the Permitted Maximum.

The amount that could be taken from a Personal Pension in the form of a tax free lump sum was 25% of the value of the fund, with further restrictions relating to any part of the fund arising from a previous transfer in from an occupational scheme. The maximum cash limits for Retirement Annuities were expressed as three times the maximum pension available, broadly equivalent to 25% but generally higher when annuity rates were higher some 20 years ago.

2. Occupational Schemes

Retirement

The pension that could be paid on retirement was limited, but there was no limit to the total contributions that could be paid in respect of any individual (although the member himself could not pay more than 15% of earnings).

The basic idea was that members would be allowed to receive a pension of up to 1/60th of final earnings for each year of company service, so that after 40 years, an individual could retire on a pension equal to 2/3rds of the earnings he was receiving in the run up to retirement. Part of the pension could be exchanged or 'commuted' for a cash sum on retirement. Members could receive a cash sum of up to 3/80ths of final earnings for each year of service, so that after 40 years, an individual could be paid a lump sum of up to 1.5 times final earnings.

This basic framework was then adjusted for different circumstances:

- If the individual joined the company with less than 40 years to go until his Normal Retirement Date (NRD), accelerated or 'uplifted' accrual rates were allowed, depending on the length of service possible.This allowed individuals joining a company as late as ten years before their NRD to receive a '2/3rds pension'. At least 20 years' service was required before a lump sum of 1.5 times earnings could be paid at NRD.
- On leaving service, the maximum benefits at normal retirement were scaled back. This was done by multiplying by the ratio of the service actually completed divided by the service that would have been served had the member remained in the company until NRD. This limit was sometimes overridden by DWP requirements, which imposed a minimum benefit entitlement for 'early leavers'.
- In July 1989, the pension limit changed to 1/30th of final earnings subject to a maximum of 2/3rds. At the same time the lump sum limits changed to 3/80ths (no accelerated accrual allowed) or 2.25 times the pension if greater. For the purposes of calculating maximum benefits and member contributions, earnings became limited to the earnings cap (still written into the Rules of some pension schemes). Some members continued to be treated under the pre 1989 rules, and were said to have pre-89 'continued rights'.

- Where a pension scheme was giving a pension greater than 'N/60ths', account had to be taken of any benefits the member had earned in other pension schemes (so called 'Retained Benefits').This was to ensure the overall limit of two-thirds final salary was not breached.
- Some members had benefits governed by a regime that was in force between March 1987 and July 1989.The applicable limits lay between the pre-87 and post-89 regimes.
- Alternative limits applied to some schemes, particularly those in the public sector or with historical connections with the public sector, which provided a separate cash sum and pension (rather than providing the cash by commuting pension). In these cases, schemes were permitted to give a cash sum of 3/80ths of earnings in addition to a pension of 1/80th of earnings, for each year of service.

Death

On death, schemes could pay a spouse's/dependant's pensions of up to 2/3rds of the limit that applied to the member's pension. For this purpose, the limit on the member's pension is calculated on the assumption that the member remained in the scheme until NRD and retired at that time taking no cash (so in many cases a dependant's pension of up to 4/9ths of earnings could be paid). Children's pensions could be paid in addition up to certain limits.

In addition, a lump sum could be paid. On death before retirement, a lump sum of up to four times earnings could be paid (plus employee contributions with interest). On death within five years of retirement, a lump sum equal to the balance of any pension instalments not received in the initial five year 'guarantee period'. On death after retirement outside this five year period, small amounts could be paid to cover funeral expenses etc.

Special rules applied to part time workers and to high earners/'controlling directors'.

Full details of all the pre 6 April 2006 limits are given in the Inland Revenue's "Practice Notes on the Approval of Occupational Pension Schemes" (also known as IR12).A tabular summary of the principal features is given below. Definitions of abbreviations used below are given at the end.

	1970 Regime	1987 Regime	1989 Regime
Employees Covered	Scheme set up and employee joined before 17.3.87	Scheme set up before 14.3.89 and employee joined between 17.3.87 and 31.5.89	Scheme set up after 13.3.89 or employee joined after 31.5.89
Final Remuneration	No limit*	Limited to £100,000 for maximum tax free lump sum calculation #*	Limited to earnings cap**
Normal Retirement			
Maximum Pension at NRD	2/3 of Final Remuneration after ten years service	2/3 of Final Remuneration after 20 years service	2/3 of Final Remuneration after 20 years service
	Uplifted 60ths' table for less than ten years service	1/30 of Final Remuneration for each year's service less than 20	1/30 of Final Remuneration for each year's service less than 20
Maximum Lump Sum at NRD	1½ times Final Remuneration after 20 years service	Uplifted 80ths' table for less than 20 years service 1½ times Final Remuneration after 20 years service. Accelerated formula for less than 20 years service (provided pension also enhanced)	2¼ times initial annual pension
Early Retirement/ Withdrawal from Membership			
Maximum pension	$\frac{N}{NS} \times P$	$\frac{N}{NS} \times P$	1/30 of Final Remuneration for each year's service, maximum 2/3 after 20 years (but N/NSxP applies if leaving scheme but not service)
Maximum Lump Sum	$\frac{N}{NS} \times LS$	3N/80 or Accelerated formula (provided pension also enhanced)	2¼ times initial annual pension or $\frac{3N}{80}$ pension or whichever is the greater
Death in Service			
Maximum Lump Sum	Four times Final Remuneration at death (or £5000 if greater) plus refund of member's contributions with interest	Four times Final Remuneration at death (or £5000 if greater) plus refund of member's contributions with interest	Four times Final Remuneration at death (or £5000 if greater) plus refund of member's contributions with interest
Maximum Spouse's Pension	2/3 of member's maximum prospective pension at NRD	2/3 of member's maximum prospective pension at NRD	2/3 of member's maximum prospective pension at NRD
Death after Retirement			
Maximum Lump Sum	Total of remaining pension instalments for balance of five year period from retirement date	Total of remaining pension instalments for balance of five year period from retirement date	Total of remaining pension instalments for balance of five year period from retirement date
Maximum Spouse's Pension	2/3 of members' maximum approvable pension at NRD, increased in line with RPI	2/3 of members' maximum approvable pension at NRD, increased in line with RPI	2/3 of members' maximum approvable pension at NRD, increased in line with RPI

N = Actual service completed with the employer (maximum 40)
NS = Potential service to NRD (may be limited to 40)
P = Maximum pension approvable at NRD
LS = Maximum lump sum approvable at NRD

* If Remuneration in any year since 5 April 1987 had exceeded £100,000, the calculation of maximum pension by reference to Final Remuneration must be calculated using the averaging method over at least five or more years, unless the employee chooses to adopt £100,000.
#* Final Remuneration limited to £100,000 for calculating maximum lump sum benefit only.
** Final Remuneration limited to the earnings cap for the year in which benefits become payable (or when pensionable service terminates if earlier).The cap was £105,600 in 2005/06.
***Where Maximum exceeded, the excess, over four times Final Remuneration, could be paid as a Widow's Pension or other Dependant's pension

The Inland Revenue did not limit the total benefits that could be paid out from a personal pension scheme (and retirement annuities) – but note that the amounts receivable as tax-free cash were controlled even then, as indicated in section 1 of the above table. Instead of limits on benefits, there were restrictive limits to the amount of contributions that could be paid in. These contribution limits were removed with effect from 6 April 2006 and today have little relevance. The Annual and Lifetime Allowances started to apply from April 2006.

8.2 TRANSITIONAL ARRANGEMENTS

There are transitional arrangements to protect individuals who had already built up pension rights under the old regime that exceeded the new Lifetime Allowance.

Section 7.3 above gives details of these transitional arrangements in 2006.

Subsequent reductions in the Lifetime Allowance have been accompanied by further transitional protection reliefs.

Summary

Before April 2006 (A-Day), to obtain preferential tax treatment, schemes had to be 'approved' under the Inland Revenue's discretionary powers. Schemes that were approved at 5 April 2006 automatically became registered schemes from that date. Members who had large pension rights under approved schemes at 5 April 2006 that were (or might be) greater than would be authorised under the new regime could apply to have these rights 'protected' using the Enhanced or Primary Protection facilities. Other forms of protection were also given to those who had rights to retire below Normal Minimum Pension Age or who had built up rights to tax free retirement lump sums greater than those permitted under the new regime. Further protection was introduced when the Lifetime Allowance was reduced in 2012 and 2014.

Self Test Questions

- What were the main features of discretionary approval, as applied before A-Day.
- In what circumstances might an individual have applied for 'protection' of his pre A-Day pension rights?
- Why might an individual with large pension rights at 6 April 2006 apply for Primary Protection and how would this affect the subsequent testing of benefits against the Lifetime Allowance?
- Why might a member have both Enhanced and Primary Protection?

INTRODUCTION

In this Chapter we will look at the rights and options available to a member who leaves pensionable service before their Normal Retirement Date.

Providing these members or their dependants with the correct benefits and making sure that all the legislative requirements are complied with is a fundamental requirement for a pension scheme. From the adviser's perspective a knowledge of these requirements will assist the advice process with his client.

9.1 EARLY LEAVERS

When an active member leaves pensionable service, the employer must notify the trustees (or, in practice, the administrator) and provide the information needed to calculate the member's benefit entitlement, for example details of their final earnings.

The factors that determine what benefits become payable and in what circumstances are:

- Whether the scheme provides DB or DC benefits
- Whether the member has opted out of the scheme as a result of being automatically enrolled, or enrolled following their request to opt in
- How much 'qualifying service' (see below) the member has completed
- Whether the scheme is contributory or non-contributory for members
- Whether the scheme was contracted out
- The rules of the scheme, for instance whether early retirement is available

9.2 QUALIFYING SERVICE

Qualifying service broadly means the period of service that is taken into account to calculate the benefits a member is entitled to when they leave the scheme. It includes any period of service before entering the scheme which is classed as pensionable and any service in respect of a transfer value brought in from a previous arrangement (the latter is referred to as 'linked qualifying service').

9.3 OPTIONS ON LEAVING

9.3.1 If the Member is Opting Out During the One-Month Opt out Period

If an eligible jobholder is automatically enrolled into scheme membership, or a jobholder is enrolled following their request to opt in, they have the right to opt out of the scheme within one month of being enrolled.

If the member exercises this right, they are treated as never having been a member of the scheme and the employer must refund to them any contributions they have paid to the scheme. The employer must generally refund the contributions within one month of receiving the opt out notice from the employee.

If any of the member's contributions have been passed across to the pension scheme, the scheme must refund those contributions to the employer along with any related employer contributions (again generally within one month of the employer receiving the opt out notice from the employee).

9.3.2 If the Member has less than Three Months' Qualifying Service in a Defined Benefit Scheme (and is not opting out within the One-Month Opt out Period) or has less than one Month's Qualifying Service in a DC Scheme

The member is usually only entitled to a refund of their own contributions including any Additional Voluntary Contributions (AVCs) they have paid.This lump sum cannot exceed the amount of the member's contributions to the scheme and is known as a Short Service Refund Lump Sum.

A deduction will usually be taken from the refund as follows: tax at the rate of 20% on the first £20,000 of contributions (including AVCs) repaid and 50% on any contributions (including AVCs) repaid over this amount.

Any investment return on AVCs or interest awarded on ordinary contributions may also be paid but must be paid gross. The member must then declare that amount to their local Inspector of Taxes. Tax will be levied directly on the individual. Such a payment is known as a Scheme Administration Member Payment.

It is worth noting at this point that the right to a refund of contributions in these circumstances only applies to members of an occupational pension scheme. Members with personal pension plans, for example, have always been entitled to a short service benefit in the plan instead of a refund.

From 1 October 2015 the law changed for members with DC benefits. From that date, members with DC benefits with more than one month's qualifying service will be entitled to a short service benefit instead of a refund of their contributions.

9.3.3 If the Member has Between Three Months' and Two Years' Qualifying Service

Usually a choice is available between:

- a refund of the member's own contributions (including any AVCs) which will be paid as described above, or
- transferring the value of their benefits, known as a cash transfer sum, to another suitable pension arrangement, such as a new employer's scheme or a personal pension scheme

Within three months of the member leaving pensionable service, the trustees must notify them of their right to a refund or a cash transfer sum. Trustees may leave this option open indefinitely or may give the member a reasonable period (usually three months) to request a cash transfer sum. If this is not taken up the option will then lapse and the refund of contributions will be paid instead.

These timescales come from TPR's Code of Practice on Early Leavers, available from:
http://www.thepensionsregulator.gov.uk/codes/code-early-leavers.aspx

Some schemes may be more generous and offer a deferred benefit to a member with less than two years' qualifying service.Where a deferred pension is offered, the member is not entitled to a cash transfer sum. Instead, they would be entitled to a cash equivalent transfer value.

Again, if the member has brought a transfer into the scheme from a personal pension or, for members with DC benefits from 1 October 2015, a refund or a cash transfer sum is not available.

9.3.4 If the Member has at least Two Years' Qualifying Service

Under the Pension Schemes Act 1993, such members are entitled to preserved benefits in the form of a deferred benefit within the scheme when they leave. A refund of contributions is not available.

Where 'preservation' applies, the member has a right to a preserved benefit payable on retirement or death on, before or after their Normal Retirement Date, in respect of all benefits (excluding lump sum death-in-service benefits) earned up to the date of leaving.

9.4 PRESERVATION AND DISCLOSURE REGULATIONS

Under The Occupational Pension Schemes (Preservation of Benefit) Regulations 1991/167, members who leave pensionable service with preserved benefits must be provided, automatically, with details of their rights and options under the scheme within two months of the trustees receiving notification of the termination of pensionable service. This includes setting out the member's right to request a transfer value but it does not require a statement of the value to be provided.

The disclosure regulations allow members with deferred benefits to request details of the benefits that would be paid at NRD or on death. If requested, this information must be provided within two months. Having received this information, members are not automatically entitled to request it again free of charge during the next 12 months.

Members can transfer their benefits to another pension scheme or to a suitable insurance policy, personal or stakeholder pension scheme. See Chapter 2 for information on transfers.

The adviser's knowledge of these procedures will help in the provision of advice.

9.4.1 If the Member has Contracted Out Rights in the Scheme

If a member has been in pensionable service of a contracted out scheme between 6 April 1978 and 5 April 1997 their accrued rights will include a Guaranteed Minimum Pension (GMP). GMP is payable at GMP payment age, which is 60 for females and 65 for males.

Before 6 April 2016, administrators had to inform NIC&EO where an employee left pensionable service with accrued contracted out rights before the tax year in which they reach their GMP payment age. NIC&EO would then issue a notice confirming the amount of the GMP.

Following the abolition of contracting out, NIC&EO no longer issue a notice. When an employee leaves pensionable service the trustees and their administrators must rely on their own records (having confirmed these as part of the GMP reconciliation process) to ensure the correct amount of GMP is recorded.

GMP must be revalued from the date contracting out employment ceased up to GMP payment age.The method of GMP revaluation is set out in the scheme rules. Often the rules allow for either of the methods described below and the trustees will have selected one when the scheme started to contract out. It must be the same for all leavers until the trustees elect to change it, the new method will then apply to all leavers from the date of the election.

Members who leave during the tax year in which their GMP payment age falls, or the immediately preceding one, do not receive any GMP revaluation.

Contracted out benefits accrued since 6 April 1997 revalue in deferment in the same way as other non GMP benefits.

942 Revaluation of Deferred Pensions

Under a DB arrangement, the trustees must increase the deferred pension between the date of leaving and retirement as follows:

Revaluation of the GMP Element

The GMP of early leavers must be revalued for each complete tax year, up to GMP payment age or death, if earlier. For members who terminated contracted out employment on or before 5 April 1997, schemes could revalue GMPs using either:

- Section 148 orders (previously called Section 21 orders) which is known as full rate revaluation
- A fixed rate
- A limited rate (full rate revaluation capped at 5% a year)

For members whose GMP is revalued at fixed rate, that rate is set at the time they left contracted out employment as set out in the table below (even though contracting out is ceasing on an ongoing basis from April 2016, these rates will remain extant for some years to come):

Date contracted out employment ended	Fixed rate
06/04/1978 – 05/04/1988	8.5%
06/04/1988 – 05/04/1993	7.5%
06/04/1993 – 05/04/1997	7.0%
06/04/1997 – 05/04/2002	6.25%
06/04/2002 – 05/04/2007	4.5%
06/04/2007 – 05/05/2012	4.0%
06/04/2012 - 05/04/2016	4.75%

For example, a member who left contracted out employment in 1994 and who has a GMP subject to fixed rate revaluation, will have their GMP revalued by 7% for each complete tax year up to their GMP payment age.

As the amount of revaluation is capped for schemes that used limited rate revaluation, they had to pay a premium to the state so that the state paid any additional revaluation that may be due. This premium was known as a Limited Revaluation Premium (LRP).

For members who terminate contracted out employment on or after 6 April 1997, schemes may only revalue using either Section 148 orders or a fixed rate. Schemes which used limited rate revaluation before 6 April 1997 had to change to either full or fixed rate revaluation for leavers from then onwards. Limited rate revaluation can continue to apply for those members who left the scheme before 6 April 1997.

With the cessation of contracting out from 6 April 2016, any active members stopped being contracted out on 5 April 2016. For some schemes their rules refer to GMP revaluation applying from the date contracted out service ended. This would mean that schemes may find they are providing a higher benefit than necessary (for example, where trustees have decided to use fixed rate revaluation, revaluation would need to be calculated as the higher of Section 148 orders and fixed rate revaluation for the period since 5 April 2016 to the date pensionable service ends and then fixed rate thereafter). Trustees were therefore given a one -year window to amend their scheme provisions to link the revaluation a member's GMP benefits to the date the member eventually leaves pensionable service rather than 5 April 2016.

Date left pensionable service of a scheme which was contracted out on 5 April 2016	Fixed rate
06/04/2016 – 05/04/2017	4.75%
06/04/2017 –	3.5%

943 Anti-franking

The GMPs of early leavers are protected by anti-franking legislation. The basic principle is that any pension in excess of the GMP is not eroded by using it to offset the revaluation of the GMP. Therefore for someone retiring at their NRD the minimum pension payable at the member's GMP payment age under the anti-franking rules is broadly the aggregate of the following:

- the pension rights accrued by the member at the time of ceasing to contract out;
- the amount by which the GMP has increased between the date contracting out ended and the date of payment;
- any pension earned whilst contracted in.

Statutory revaluation on benefits in excess of the GMP (see below) must be paid in addition.

944 Non GMP

Different rules apply to non GMP benefits, which:

- for a scheme which was previously contracted out include:
  - pension accrued prior to 6 April 1997, in excess of GMP
  - pension accrued from 6 April 1997 to 5 April 2016 on the reference scheme test basis;
- for a scheme that was not contracted out, all pension.

If a member leaves pensionable service at least one full year before NRD, the Pension Schemes Act 1993 requires that the deferred benefit, in excess of the GMP, is revalued up to NRD. The revaluation method depends on the nature of the scheme.

For members who leave pensionable service on or after 1 January 1991, all of the deferred benefit in excess of the GMP must be revalued. (Partial revaluation must apply for pre-1991 leavers unless they left before 1986.)

For final salary schemes, deferred benefits must be revalued as follows:

- the deferred benefit accrued prior to 6 April 2009 must be increased for each complete year between leaving pensionable service and NRD by the lower of the rise in prices over the period and 5% a year compound;
- the deferred benefit accrued after 5 April 2009 must be increased for each complete year between leaving pensionable service and NRD by the lower of the rise in prices over the period and 2.5% a year compound.

Up to 1 January 2011, the rise in prices was measured using the Retail Prices Index (RPI). After this date, the Consumer Prices Index (CPI) is used.

Note that the above are minimum revaluation requirements and some schemes may provide higher revaluation levels. For instance some schemes:

- will still apply the 5% cap to benefits accrued after 5 April 2009 or adopt the lower rate at a later date;
- continue to use RPI instead of CPI as the measure for price inflation for some or all of the member's benefits;

For CARE schemes, the revaluation requirement under the Pension Schemes Act 1993 is met by either:

- revaluing deferred benefits in the same way as final salary schemes;
- revaluing the salaries for deferred members in the same way that would have applied if the member had continued to be in active service.

For DC arrangements revaluation does not apply. Any change in value, positive or negative, will be solely down to investment returns on the member's pot up to the date they take their benefits.

9.45 Leaving Pensionable Service (outside of the Opt out Period where the scheme is being used as an Automatic Enrolment Scheme) without Leaving Employment

The Social Security Act 1986 gave employees the right to cease active membership of their employer's scheme at any time from 6 April 1988 without leaving employment. The scheme may impose certain conditions, such as the period of notice which the employee must give before leaving pensionable service (which may be up to three months) and the terms for re-joining in the future.

Leavers in this category have a statutory right to transfer out any part of their entitlement which was earned after 5 April 1988 (entitlement earned before 6 April 1988 can be transferred once they leave the company's employment). It is likely, however, that the scheme rules will be more generous and allow the transfer of the whole benefit without the member leaving employment.

9.5 PAYMENT OF DEFERRED PENSIONS AT NORMAL RETIREMENT DATE

Typically the scheme will send a letter to the member's last known address six months before NRD. If the member does not respond, other attempts can be made to get in touch e.g. through the employing company's records, former colleagues, the DWP letter forwarding service, specialist tracing agency etc.

If all this proves unsuccessful then the pension can be held in suspense until the member makes contact or a periodic review of suspended cases proves successful. Once contact has been made procedures will be similar to those for an active member but the following points should be kept in mind:

- The terms attaching to the pension might be governed by the scheme rules in force when the member left pensionable service, e.g. the eligibility for an automatic dependant's pension
- Some proof of identity should be obtained to ensure contact has been made with the correct individual.

If a deferred benefit is not claimed within six years of entitlement arising, the scheme's rules may provide that the back payments due for periods more than six years ago may be forfeited, but not the right to the last six years' instalments or any future instalments. The rules may also give the trustees discretion to allow back payments due for periods more than six years ago to be paid in any event.

When retiring from deferred status, the same disclosure requirements apply as when retiring from active membership.

The problem for occupational schemes in tracing members with deferred pensions was discussed above. A similar problem applies for members with deferred pensions who cannot trace the body responsible for paying their deferred pension. This can be for a number of reasons, such as company take-overs, mergers, liquidations, changes of names etc. Members can use the Pensions Tracing Service (operated by the DWP – see **https://www.gov.uk/find-lost-pension**) to trace former pension schemes.

9.6 PAYMENT OF DEFERRED PENSION AT OTHER TIMES

Members will generally have the option under the scheme rules to take their pension early or possibly to postpone it beyond NRD. This is usually subject to the consent of the trustees and may be subject to additional requirements such as still being in employment if the member wishes to postpone taking their pension. The pension will normally be reduced or increased for early or late payment respectively.

Deferment after age 75

If the pension is not put into payment before the member's 75th birthday a Benefit Crystallisation Event (BCE) occurs automatically at age 75 and the deferred pension must be tested against the member's remaining Lifetime Allowance (LTA). If the trustees are unable to obtain the information required to perform an accurate LTA test, they should exercise their reasonable judgment to decide whether any Lifetime Allowance charge is due at the member's 75th birthday.

Death of a Deferred Member

The scheme rules may provide for the payment of a dependant's pension if the member dies after leaving pensionable service and before the deferred pension comes into payment. If the scheme is contracted out:

- widows must receive a GMP in respect of all contracted out service prior to 6 April 1997, and a pension in respect of contracted out service from 6 April 1997;
- widowers (including widowers from same sex marriages), widows of female members under a same sex marriage and surviving civil partners must receive a GMP in respect of contracted out service between 6 April 1988 and 5 April 1997, and a pension in respect of contracted out service from 6 April 1997.

Where GMPs have been converted to normal scheme benefits, survivors' benefits must be provided from the converted benefits in the same circumstances and for the same service periods that would have applied had the GMP not been converted.

9.7 RECORDS FOR LEAVERS

When members leave pensionable service with an entitlement to a deferred benefit, schemes must keep additional records to those already kept during their active membership, to ensure that revaluation on any DB pension up to the date of payment is correctly applied on for example:

- any GMP in respect of pre 6 April 1997 contracted-out service
- any excess pension subject to compulsory revaluation (for leavers before 1 January 1991, this should be split between excess benefits earned before and from 1 January 1985)
- any pension earned from 6 April 1997 to 5 April 2005
- any pension earned from 6 April 2005 to 5 April 2009
- any pension earned after 5 April 2009.

If a member transfers out or takes a refund of contributions, records must be kept of how much was paid and when and, in the case of a transfer, details of the receiving arrangement.

Summary

When an individual leaves pensionable service, various factors determine what benefits will be payable, if any. All leavers with at least two years' qualifying service are entitled to a preserved benefit on leaving.

Under a DB arrangement, the trustees must increase deferred pensions between the date of leaving and retirement. The rate at which they are increased depends on the type of benefit, when the member left pensionable service and whether the scheme revalues pensions in line with the statutory requirements or at a higher rate.

Defined contribution benefits are not subject to revaluation. Any change in value will depend on the investment returns that are received on the member's pot and on charges deducted.

If a deferred member with contracted out benefits dies in deferment, a pension must be provided for the member's widow, widower, surviving civil partner or widow/widower from a same sex marriage. Schemes may provide more than this statutory minimum.

Self Test Questions

- Describe the process for bringing the benefits of a deferred member into payment when they reach NRD
- Explain the basic principle of the anti-franking legislation
- List the various options a member has when they leave a scheme
- Distinguish between fixed rate revaluation and limited revaluation for the GMP element of a deferred pension

INTRODUCTION

This Chapter explores the administrative requirements associated with transfers of benefits. The advice aspects of transfers are covered in Retail Advice and Regulation.

10.1 TRANSFERS IN

Schemes may allow members to transfer in benefits from a previous pension arrangement.

Transfers into DB schemes on a defined benefit basis are very unusual nowadays, and typically either provide the member with a fixed amount of pension in the receiving scheme or a period of additional pensionable service, which is taken into account when calculating benefits when they eventually leave the scheme. From April 2016 future contracting out ceased for DB schemes but the structure of pre-2016 DB benefits still needs to be borne in mind.

Transfers into DC schemes will provide an increase in the member's fund value, which will represent the transfer value received from the previous scheme.

In general, administrators deal directly with the previous arrangement in order to facilitate transfers effectively and efficiently on the member's behalf. The receiving arrangement will obtain explicit authority from the member in order to do so, and correspond directly with their previous arrangement.

Care must be taken to ensure that the receiving scheme can accept the benefits to be transferred. Following the abolition of contracting out on a DC basis, it became possible for DC schemes to accept former protected rights without restriction. In addition, legislation was brought in to allow DC schemes to accept GMPs and benefits in respect of contracted-out service from 6 April 1997 providing certain safeguards are met, and that the scheme rules allow.

The information required from the transferring arrangement will typically include:

- The member's personal details
- The name of the transferring scheme
- The type of arrangement (e.g. DB scheme, personal pension)
- Whether any contracted out benefits are included in the transfer value
- Pensionable service details
- Whether the transfer contains a transfer in from a previous scheme and, if so, details of this
- Value of member's benefits and contributions included in transfer, including any AVCs
- Current transfer value and whether any guarantee period applies
- Statement of equalisation for pensionable service post 17 May 1990 (if applicable)
- Confirmation of any court orders on the member's benefits (for example Earmarking or Pension Sharing Orders, maintenance or bankruptcy orders)

When the administrator of the receiving scheme has all the necessary information, an illustration of the benefits to be provided in the new scheme will be forwarded to the member, together with instructions on what the member should do if they wish to proceed with the transfer. If the transfer includes contracted out benefits, then an explanation of what these benefits provide will need to be included within the illustration.

Whilst the value of benefits transferred from a DB scheme will be guaranteed for a period (normally six months from the date of the original calculation provided the transfer is formally accepted within three months), transfers between DC schemes are not guaranteed, as the value of the units to be sold/purchased will vary according to market conditions at the time of transfer. This should also be brought to the member's attention by the transferring scheme.

If the member decides to proceed with the transfer in, they will be required by the receiving scheme to complete a discharge form, which will also include an authority for the administrator to instruct the previous pension arrangement to transfer the member's benefit to the new scheme. The receiving scheme will have to sign to confirm they are a registered pension arrangement with HMRC and provide payment instructions.

On receipt of the transfer monies, particularly when the member is to be awarded DC benefits in respect of the transfer, it is important for the administrator of the receiving scheme to undertake prompt investment of the transfer amount, so that the member does not suffer any potential financial loss; for example, if investment returns are favourable whilst the transfer monies are being held in cash.

Full details of the transfer will need to be entered on the member's record, and the part of the transfer value representing the employee contributions should be separately identified. This will also help if the member subsequently leaves the receiving scheme and decides, at a later date, to transfer out all of his benefits (including the existing transferred in benefit) to another registered pension arrangement.

10.2 TRANSFERS OUT

Members who leave a pension scheme before retirement usually have the right to transfer the value of their benefits to another pension arrangement. The amount transferred is called the 'Cash Equivalent Transfer Value' (CETV) of the member's benefits.

The right to transfer their benefits to another suitable pension arrangement depends on the type of benefits the member has in the transferring scheme as different rules apply.

10.2.1 Members with Defined Benefits

Members with defined benefits (also known as safeguarded rights in this context) who leave pensionable service at least one year before their NRD with a deferred benefit in the scheme have a statutory right to transfer the CETV of their deferred benefits to another suitable pension arrangement.

There is no statutory right to transfer rights earned under an occupational pension scheme before 6 April 1988, if the member leaves pensionable service without leaving employment.

The scheme rules may allow members to transfer their benefits even where they do not have a statutory right to do so. Given the pension freedom available to individuals with money purchase pots, some schemes may now offer or provide details of a member's cash equivalent transfer value alongside retirement quotations.

Where a member wishes to transfer their DB pension to a pension arrangement that provides flexible benefits (i.e. a DC arrangement, such as a personal pension plan) and the transfer value (before any reduction to reflect the funding position of the scheme) is £30,000 or more, the member will have to have obtained appropriate independent advice regarding the proposed transfer.

Before making a transfer payment, the Trustees (or more likely the administrators, on their behalf) must check that the member has received that advice.

Members with public sector DB pensions cannot transfer their pension benefits to another pension arrangement providing flexible benefits.

10.22 Members with Defined Contribution Benefits or Other Flexible Benefits (i.e. a Cash Balance Pension)

Members with DC or other flexible benefits also have a statutory right transfer their benefits to another suitable pension arrangement. The right to transfer applies right up to the point the benefits are taken.

Where a form of guarantee is provided, the benefit will fall into the safeguarded benefit category and the transfer would therefore be subject to the advice requirement. Examples of safeguarded benefits in a DC scheme are where the pre 97 fund has a GMP underpin is provided, or, the post 97 fund is subject to the Reference Scheme Test underpin, or where there are guaranteed annuity rates available at retirement.

10.23 Members with More Than One Benefit Type

If a member has more than one benefit type in a scheme, such as a final salary pension plus DC AVCs, they have a separate right to transfer the benefits from the different categories.
For example a member could transfer their final salary pension and leave the DC benefits in the scheme, or could transfer their cash balance benefits and leave their final salary and DC benefits in the scheme.

However, the statutory right applies to all benefits within the same category. A member with DC AVCs and a DC section has to transfer out all DC benefits together, unless the scheme rules allow partial transfers.

10.24 Transferring Contracted Out Benefits

Where contracted out benefits are transferred, unless those rights are being transferred to another contracted out scheme, the member will need to confirm in writing to the transferring scheme that they:

- Have received a statement from the receiving scheme showing the benefits to be awarded
- Accept that the benefits may differ in amount and form
- Understand that there is no requirement for the receiving scheme to provide survivors' benefits in respect of the transfer payment.

10.25 Transfers to an Overseas Pension Arrangement

An overseas pension transfer is broadly similar to a transfer to another UK registered pension scheme with the additional requirements that the overseas arrangement is a Qualifying Recognised Overseas Pension Scheme (QROPS) and that a Lifetime Allowance test takes place. In addition, any transfers requested on or after 9 March 2017 may be subject to an Overseas Transfer Charge (see below). If the transfer includes contracted out benefits, there are further requirements which must be satisfied.

To become a QROPS the overseas scheme must make certain declarations and undertakings to HMRC. Prior to August 2015, HMRC provide a list of Qualifying Recognised Overseas Pension Schemes. Since then, HMRC, concerned that use of the word "Qualifying" gave some sort of guarantee that these schemes were free of fraudulent activity, state in their introductory comments to the ROPS list: "HMRC can't guarantee … that any transfers to them will be free of UK tax. It is your responsibility to find out if you have to pay tax on any transfer of pension savings."

It is extremely unlikely that schemes will allow a transfer to be paid to an overseas arrangement which is not a QROPS because:

- a member does not have a statutory right to transfer to an overseas pension scheme which is not a QROPS, so any such transfer made would be paid on a discretionary basis and subject to the provisions of the scheme rules;
- any such transfer would be an unauthorised payment and would be subject to a tax charge both on the scheme and the member.

The member will need to complete a declaration to enable the administrator to determine the member's available LTA, because a transfer to a QROPS is a Benefit Crystallisation Event (BCE) if paid before the member reaches age 75.

Before the transfer is completed the member must sign a declaration acknowledging that there are circumstances where they may have to pay UK tax on the transfer or on a later payment from the overseas scheme even if they are not resident in the UK.

If the value of the member's benefits exceeds their remaining available LTA, a Lifetime Allowance charge of 25% on the excess must be deducted from the transfer value and accounted for in the next quarterly Accounting for Tax return to HMRC. Details of all overseas transfers must also be reported to HMRC within 60 days of the transfer being made.

If the member has relied on Transitional Protection to avoid or reduce a Lifetime Allowance charge on a transfer to a QROPS, this must also be reported on the scheme's annual event report.

Overseas Transfer Charge

Any transfers to a QROPS requested on or after 9 March 2017 are potentially subject to an Overseas Transfer Charge of 25% on the total transfer value (after any Lifetime Allowance Charge has been deducted).There are a number of exemptions under which the charge is not payable and the Scheme Administrator should check whether any apply before making the transfer payment.

The transfer is exempt from the Overseas Transfer Charge if any of the following conditions are met:

- the member is resident for tax purposes in the same country in which the QROPS is based;
- the member is resident for tax purposes in the EEA and the QROPS is based in the EEA;
- the QROPS is an occupational pension scheme and the member is an employee of a participating employer and is participating in that scheme as a result of that employment;
- the QROPS is a scheme in respect of an international organisation (for example the European Union) and the member is an employee of a participating employer and is participating in that scheme as a result of that employment; or
- the QROPS is an overseas public service pension scheme and the member is an employee of a participating employer and is participating in that scheme as a result of that employment.

If none of the exemptions apply, then the Overseas Transfer Charge is payable.The Scheme Administrator must deduct the charge prior to paying the transfer to the QROPS and pay the charge to HMRC via the quarterly Accounting For Tax return.

Where one of the exemptions applies the Scheme Administrator of the transferring scheme must inform the member and the receiving QROPS and set out which exemption has been met.

If an Overseas Transfer Charge was not payable due to the member being a tax resident either in the same country as the QROPS, or in the EEA while the QROPS is also based in the EEA, and the member's status changes before the end of five complete tax years following the transfer, then the charge will then become payable. Conversely, if none of the exemptions applied at the time of the original transfer, and a charge was paid, but the member subsequently became resident in a country which means that one of the exemptions would apply, then HMRC will refund the Overseas Transfer Charge. In order for the refund to be paid, the change in residency must occur prior to the end of the fifth complete tax year following the original transfer.

10.3 STATUTORY DISCHARGE

Where a member exercises their statutory right to a transfer, the trustees of the transferring scheme have a full statutory discharge, so that they are not required to provide the member with any benefits to which the cash equivalent related, so long as the receiving arrangement satisfies prescribed requirements. The exact requirements vary depending on whether the receiving arrangement is an occupational scheme, a personal pension or a buy-out policy.

A member with a statutory right to a transfer can split the cash equivalent between as many occupational pension schemes, buy out policies and personal pension arrangements as they wish although, generally, for the statutory discharge to apply, all of the value in respect of that benefit type must be transferred.

Where the member's benefits include any contracted out elements there are some additional requirements that must be met. If the receiving scheme is also a former contracted out scheme then, provided it protects the transferred contracted out rights (i.e. continues to treat any GMP benefit as GMP following the transfer), the transfer can be made without any additional requirements.
Alternatively, contracted out rights can be transferred to a scheme that was never contracted out provided the member consents in writing to the transfer and confirms in writing that they:

- have received a statement from the receiving scheme setting out the benefits they will receive;
- acknowledge that the benefits in the receiving scheme may be in a different form and amount to those which would have been payable in the transferring scheme; and
- acknowledge that there is no statutory requirement for the receiving scheme to provide for survivors benefits out of the transfer value.

If trustees allow a member to transfer their benefits where a statutory right does not exist, the trustees do not have a statutory discharge of their liability to provide benefits for the member. In these cases trustees will usually insist that the member completes a form to acknowledge that the trustees will no longer be obliged to provide benefits for them.

10.4 NOTIFYING NIC&EO OF THE TRANSFER OF CONTRACTED OUT BENEFITS

Following the cessation of contracting out on 6 April 2016 it is no longer necessary to notify NIC&EO that a member's contracted out benefits have been transferred.

10.5 HMRC REQUIREMENTS

When a member transfers benefits they retain their right to Enhanced Protection, Fixed Protection 2012, Fixed Protection 2014 or Fixed Protection 2016 unless the transfer is not a permitted transfer. A transfer will be a permitted transfer if it is a transfer to a DC arrangement or, in limited circumstances, a transfer to a DB arrangement.

When a member transfers benefits, however, they will lose their right to a protected pension age of below 55 or rights to a 'grandfathered' Pension Commencement Lump Sum (PCLS) (i.e. a PCLS of more than 25% of the value of the member's benefits – see Table in Chapter 7 to understand how this might arise) unless the transfer is part of a block transfer, which is the transfer of benefits for more than one member as a single transaction.

A transfer from a UK registered pension scheme to another UK registered pension scheme is a recognised transfer under the Finance Act 2004. No tax charges or sanctions apply to recognised transfers. A recognised transfer from one registered pension scheme to another is not a Benefit Crystallisation Event (BCE).

Treatment of the value transferred for the purpose of the member's pension input amount (PIA) calculation for the tax year in which the transfer takes place is as follows:

- Where the transferring scheme is one under which the member has a DB arrangement, the value of the benefits transferred in the Pension Input Period (PIP) (calculated as sixteen times the annual pension entitlement, plus any separate lump sum entitlement) is included in the member's closing value in that arrangement (so it is added back in at its value at the time of the transfer)
- Where the receiving scheme is one under which the member has a DB arrangement, the value of the benefits arising from the transfer payment in the PIP is deducted from the member's closing value in the arrangement (so it is subtracted at its value at the time of the transfer). For future PIPs, the transferred in benefits would be included in both the opening and closing benefits under the receiving scheme

A transfer from a registered pension scheme to a non-registered scheme is not a recognised transfer. It is an unauthorised payment and will lead to tax charges against the member and the trustees of the transferring scheme. Members do not have a statutory right to a transfer that is not a recognised transfer, so any such transfers would only be paid at the discretion of the trustees and in accordance with the provisions of the scheme rules.

10.6 CALCULATION AND PAYMENT OF TRANSFER VALUES

The trustees of registered pension schemes are responsible for determining the basis for calculating transfer values, and the assumptions used in DB transfer calculations, after taking advice from their actuary. This responsibility applies not only to Cash Equivalent Transfer Values, but also to cash transfer sums for short service leavers, valuations of benefits for divorce purposes and other transfer values for members who do not have a statutory right to transfer their benefits.

Trustees are also responsible for determining how to calculate benefits on a transfer in to the scheme.

The Occupational Pension Schemes (Transfer Values) Regulations 1996/1847 require trustees to calculate an 'initial cash equivalent'. This is the minimum cash equivalent, calculated using a prescribed approach, before any reductions are applied.

The final 'cash equivalent' may be either:

(a) The initial cash equivalent minus any reduction (where the trustees have decided to reduce transfer values due to the scheme being underfunded), or
(b) An alternative cash equivalent, provided this is higher than (a) above

The initial cash equivalent must be calculated using an 'actuarial basis' and must represent 'the amount at the guarantee date which is required to make provision within the scheme for a member's accrued benefits, options and discretionary benefits'.

When a member requests a statement of their cash equivalent transfer value, a calculation of their cash equivalent must be made with an effective date no later than three months after the date of the request. The effective date is known as the guarantee date. Where, for reasons beyond their control, the trustees are unable to calculate the transfer value within the three months, the time limit may be extended for up to a further three months.

A written 'statement of entitlement' must be issued to the member by the guarantee date, which is the period of ten days (excluding Saturdays Sundays, Christmas Day, New Year's Day and Good Friday) ending on the date on which the statement of entitlement is provided to the member. The statement of entitlement must include a statement of the guaranteed cash equivalent and the guarantee date.

For DC benefits, the transfer value is typically the value of the member's pot at the time the transfer is made. The amount is not guaranteed in these circumstances.

If a member exercises his statutory right to a transfer payment (by making a formal written application to the trustees) within three months of the guarantee date, the guaranteed cash equivalent must be paid within six months of the guarantee date.

It is essential that administrators maintain accurate records of the destinations of transfer payments.This prevents discrepancies on retirement when members attempt to trace their benefits but do not recall transfers. Administrators must also ensure they receive the relevant confirmation from the receiving arrangement, certifying that they meet the statutory criteria, to ensure that the trustees receive the statutory discharge.

10.7 AVOIDING TRANSFERS TO 'PENSION SCAM' SCHEMES

Both TPR and HMRC have become increasingly concerned about the number of transfers to 'pension scam' schemes. These are schemes which, although apparently operating as normal registered pension schemes, nonetheless give members early access to their pension savings, for example in the form of a loan or cash payment, in breach of HMRC rules. Such arrangements would result in unauthorised payment charges on the member and could result in the member losing most of his pension savings.

To help administrators and trustees to detect and deter such transfers, TPR has provided guidance for trustees together with materials for them to use when communicating with members. These can be found on TPR's website at: **http://www.thepensionsregulator.gov.uk/trustees/pension-scams-trustees.aspx.**

TPR expects trustees and administrators to issue the member's booklet to members who enquire about a transfer.

In response to concerns that it is too easy to register a pension scheme that might be used to facilitate a scam, HMRC has tightened up its registration process for new schemes by moving away from a 'process now, check later' approach. Scheme registration is no longer confirmed on successful submission of the online form: instead HMRC conducts a risk assessment before determining whether or not to register the scheme. HMRC has also been given broader powers in relation to the registration and de-registration of schemes to prevent pension scams.

The Pensions Administration Standards Association (PASA), an independent body set up to raise standards in the pensions industry, has developed a Code of Practice on due diligence, to help trustees and administrators when dealing with requests for a transfer of benefits.

Avoidance of Pension Scams is considered in more detail in Retail Advice and Regulation.

Summary

Members who leave pensionable service before retirement usually have the right to transfer the value of their benefits to another pension arrangement. How the transfer value is calculated is determined by The Occupational Pension Schemes (Transfer Values) Regulations 1996/1847.

If a member exercises their statutory right to take a transfer value the transfer must be completed within a specified timeframe. A transfer from one UK registered scheme to another is not a BCE.

A Lifetime Allowance check must be carried out before a transfer to a Recognised Overseas Pension Scheme is made because such a transfer is a BCE. There may also be an Overseas Transfer Charge payable.

Self Test Questions

- Outline the steps being taken to combat transfers to pension scam schemes
- List the information a transferring arrangement will need to provide when a member is transferring benefits into the scheme
- Briefly describe the process of transferring benefits to an overseas scheme

INTRODUCTION

The main function of a pension scheme is to provide benefits for and in respect of members who are retiring, so it is important to understand the range of benefits that may be available.

This Chapter sets out the types of benefits that might be payable on the retirement of a scheme member and how to comply with the necessary legislative requirements.

Not all benefits are available under every pension scheme and the availability of some options depends on the type of benefits the member has accrued.

Advisers need to be aware of the options to which their clients might he entitled from their scheme membership. Specific entitlements which the client may have obtained, such as transitional protection (see Lifetime Allowance section above), also should not be overlooked. Schemes may not necessarily be aware of such rights which are specific to an individual who perhaps obtained those rights when they were not members of the scheme or simply chose not to let their employers know.

11.1 RETIREMENTS

Pension schemes will typically have a specified 'Normal Retirement Date' (NRD) which is the age at which members are expected to start receiving their pension. Different schemes may use different terms for NRD including Normal Pension Date, Normal Retirement Age or Normal Pension Age. Individual personal pension schemes will also note a projected retirement date around which investment strategy may be structured or which is used by the provider to contact the member shortly before retirement. Members may, however, retire earlier or later than this expected age.

Following the abolition from 1 October 2011 of the default retirement age, which enabled employers to make staff retire at 65 regardless of their circumstances, employers cannot automatically retire employees from employment (except where a special retirement age: e.g. air traffic controllers or police, can be objectively justified).This may have affected how pension schemes set their NRD and in turn the calculation of early and late retirement pensions.

We will look at the position for retirements at NRD first, and then consider the additional issues that might apply when retirement is from a different age.

Two main types of pension must be distinguished for this part:

- A scheme pension, meaning a pension provided from an employer's DB or DC arrangements or by an insurance company selected by the trustees. Where DC benefits are involved, the trustees must have given the member the opportunity to have a lifetime annuity instead
- A lifetime annuity (an annuity contract purchased from an insurance company), from DC arrangements only

In addition, the Finance Act 2014 introduced a number of additional options that could be made available to members of pension schemes with DC benefits (this includes any benefits arising from a member's Additional Voluntary Contributions (AVCs) that provide DC benefits).These are also considered below.

11.2 RETIREMENT AT NORMAL RETIREMENT DATE

When a member is approaching their Normal Retirement Date (NRD) the administrator should write to the member to let them know what options are available from the scheme. Where the member has any DC benefits, this should be at least four months before the member's retirement date.

A member's actual retirement benefits may depend on his pensionable earnings at or shortly before retirement (for DB arrangements) and, for DC arrangements, the contributions paid to up to retirement and the value of the retirement pot at the time.

Where retirement figures are provided in the run up to retirement, the quotation should make clear that the final benefits payable might change.

The options that are available to the member depend on the scheme rules and also on the type of benefits the member has. These can include

- A Scheme Pension – this is a pension provided directly by the pension scheme, or by an insurance company chosen by the Trustees. This can be from either a DB arrangement or a DC arrangement (although if from a DC arrangement, the member must also have been given the opportunity to choose an alternative annuity provider)
- A Lifetime Annuity – this is a pension provided by an insurance company that is purchased with the value of a members DC retirement pot. There are different types of annuity that the member can select. These are described below
- A Pension Commencement Lump Sum (PCLS) – this gives members the opportunity to take up to 25% of the value of their pension benefits as a tax free cash lump sum (occasionally more than 25% for members with certain pre-2006 rights). For DB arrangements this is usually provided by giving up some their DB pension (known as commutation) although some schemes may provide it in addition. For DC arrangements, the PCLS is usually deducted from the retirement pot before it is used to provide a pension
- Trivial Commutation Lump Sum – where a member has a small DB pension and the total value of all their pension benefits across all pension arrangements does not exceed £30,000 (for payments on or after 27 March 2014), they might be able to take the whole benefit as a lump sum, with one quarter being paid tax free
- Small Lump Sum – where a member has pension rights in a scheme with a value not exceeding £10,000 (for payments on or after 27 March 2014).The whole amount can be taken as a lump sum, with one quarter being paid tax free
- Income Drawdown – members with DC benefits can, instead of using their retirement pot to purchase an annuity, choose to keep their pot invested (after taking any PCLS) and take an income directly from it. Retail Advice and Regulation gives more detailed information about income drawdown arrangements
- Uncrystallised Funds Pension Lump Sum – as an alternative to Income Drawdown, a member can choose to take part or all of their retirement pot as a single lump sum, or a series of lump sums. 25% of each lump sum is paid tax free with the remainder subject to Income Tax at the members marginal rate
- Full Encashment (Pensions Freedom) – regardless of the size of his pension/pension pot, a member may encash the whole of his entitlement. However where the value exceeds £30,000 he must obtain authorised financial advice. Income Tax will be payable (normally) on 75% of the fund value

The Money Advice Service produces a helpful booklet that schemes can use to meet their obligations to let members with DC benefits know about the various options.

Where the member has any flexible benefits, that is any benefits from a DC arrangement (including AVCs) or Cash Balance benefits the member must also be told about a free guidance service known as Pension Wise. This service was set up by the Government and provided by The Pensions Advisory Service and the Citizens Advice Bureau. The guidance can be either face to face or by telephone and is intended to help members understand the options they have available in respect of their DC benefits.

Once the member has decided on the type of benefits they want, they should be given generic risk warnings about the retirement options available and the administrator should also tell the member what actions he needs to take to enable the benefits to be paid. For example:

- Confirming which benefits he requires
- Completion of a bank mandate to enable the benefits to be paid to the member's bank account (if benefits are to paid from the scheme)
- Completion of a declaration confirming whether they have previously crystallised (taken) any pension benefits from other registered pension schemes, or whether they will do so before or on the same day as they take benefits from this scheme
- Completion of any documents needed by the scheme to transfer their benefits to another pension arrangement
- Provision of birth and marriage/civil partnership certificated of the member and spouse/civil partner (if not already produced)

11.3 RETIREMENT OPTIONS

11.3.1 Scheme Pension

A scheme pension is typically provided by a DB arrangement although they can be paid in respect of DC arrangements

Scheme pensions must:

- be payable for the life of the member
- be paid at least annually
- not be capable of being reduced year on year (except in limited circumstances)
- paid directly by the Scheme Administrator, or by an insurer chosen by the Scheme Administrator.

Where a scheme pension is paid in respect of a DC arrangement, the member must have been given the opportunity to select an alternative annuity provider. This is known as the Open Market Option.

11.3.2 Lifetime Annuity

The typical method of providing a retirement income from a DC arrangement is via the purchase of an annuity with an insurance company.

An annuity is an insurance product by which the insurer guarantees to pay a regular income for the rest of the member's life in exchange for the value of the member's accumulated retirement pot.

Once set up, the basis of the annuity is fixed, so it offers a secure lifetime income, regardless of stock market performance. It does however mean that the member is tied to the terms of the annuity even if the market conditions are not favourable at the time. Income from an annuity is taxable in the same way as most other sources of income (i.e. through PAYE) and depends on the member's individual tax liability.

The value of a member's pension fund at retirement depends on such things as the amount of contributions paid into it, the investment returns on that money and the investment manager charges deducted. Similarly, the amount of benefits that a member's pension fund will be able to buy at retirement depends on several things, including the cost of buying a pension and what benefit options they choose on retirement. A member's age at retirement also affects the amount of pension they can buy, because the younger a member is the longer the pension is expected to be paid for, and the higher the cost of buying the annuity. Pension projections, known as Statutory Money Purchase Illustrations (SMPIs), which are provided as part of the member's annual benefit statement should give members an idea of the level of income to expect.

The cost of buying an annuity is closely linked to interest rates and how long people are expected to live. As future interest rates are uncertain, no guarantee can be given as to the size of the pension a member will be able to buy with their fund in the future.

11.3.3 Open Market Option

Annuities are provided by many different insurance companies. They offer different annuity rates and these change frequently. This means that at any particular time, some firms will be more competitive than others. An Open Market Option gives members the right to 'shop around' for annuities from external providers to compare what is on offer.

By offering an Open Market Option, the trustees/managers can be assured that the member has the ability to obtain the best annuity available at the time of retirement. There is no need for the trustees/managers to check current rates with each provider individually; there are a number of firms which offer these services on a chargeable basis.

Members are strongly recommended to take independent financial advice when looking at the Open Market Option.

11.4 ANNUITY OPTIONS

The scheme rules may determine the type of annuity the member may buy. For example, legislation used to require that annuities purchased with contributions made after 6 April 1997 had to increase in line with Limited Price Indexation (LPI). Although this requirement has now been removed from legislation, the old requirement may still be incorporated in the scheme rules.

Leaving aside the constraints that may exist by either scheme rules or legislation, there are currently a number of options available which can offer greater flexibility over future income. For example:

- Taking a pension commencement lump sum and having a reduced annuity
- An annuity that provides for a spouse or dependant's pension on the member's death
- A flat rate annuity or one that increases in payment to counter the effects of inflation.
- An annuity with an attached guarantee period. This guarantee period runs from the date of retirement. It means that, should the member die within this guarantee period, the remaining pension payments that would have been made until the end of the period are paid to his spouse or dependants

11.4.1 Enhanced Annuities (Impaired Life Annuities)

Annuity providers will pay a higher income if the member has certain medical conditions. For example, the annuity provider may be able to offer a better income (on the same fund value) if the member:

- Smokes, and has done so for a significant amount of time
- Takes regular medication
- Suffers from chronic asthma
- Has high blood pressure
- Has recently undergone major surgery
- Suffers from diabetes
- Has ever suffered a serious illness such as cancer, stroke, or multiple sclerosis

This is because the length of time the annuity provider would expect a member to live, if they fell into any of the categories above, would be less than that of a healthier member.

11.4.2 Annuity Documentation

It should be noted that annuity rates offered are generally guaranteed for only a limited period.Therefore, it is important that as soon as the member has completed the necessary paperwork, the fund is disinvested and paid across to the provider promptly.

There is normally a considerable amount of paperwork required to set up an annuity.The member will usually be required to provide:

- An application form
- Medical questionnaire
- Original birth certificate
- If a spouse or dependant's pension is also being provided, then the spouse/dependant's birth certificate will also be required, together with a marriage certificate if appropriate
- If the annuity is being set up in the trustees' name, the trustees will also be required to complete the application form

11.5 ALTERNATIVES TO BUYING AN ANNUITY

Recently, more members have begun to explore alternative options to the traditional route of annuity purchase. This may be because they do not need the security and regular payments provided by an annuity and would rather leave their pension fund invested, or it is felt that the current annuity rates do not provide value for money. While this provides more flexibility it does carry more risk.

Annuities have become more expensive. This is largely as a result of increased life expectancy and lower investment returns on Fixed Interest assets, which are used by insurers to back the annuity policy. Now that people are living longer, annuity purchase may involve locking in pension funds into a product that is fixed earlier on in an individual's life. It is very difficult for members to be able to determine the right annuity type and right death benefits given that their lifestyle may change significantly in later years. Also, annuities are fixed meaning it is not possible for income to fluctuate (outside of indexation within the terms of the annuity contract), which can cause issues with tax planning in later years. Due to this, a number of alternatives to annuity purchase have grown in popularity.

The amount of choice available to members with DC arrangements has increased even more since the Finance Act 2014, following the introduction of new pension flexibilities.

The alternatives to buying an annuity are:

- Income withdrawal
- Short term annuities
- Uncrystallised Funds Pension Lump Sums (UFPLS)

These alternatives are outlined below considered in further detail in Retail Advice and Regulation.

11.5.1 Income Withdrawal

The term 'Drawdown Pension' replaced the previously used terms 'Unsecured Pensions' and 'Alternatively Secured Pensions' from 6 April 2011 as part of the changes introduced by the Finance Act 2011. Drawdown Pension can be started from age 55 onwards, unless the member has a protected pension age or is retiring earlier due to ill health.

Rather than use their DC pot to buy an annuity and individual may prefer to leave their pot invested, and draw an income directly from it. This is known as Income Withdrawal.

At retirement a member can take up to 25% of their pot tax-free as a pension commencement lump sum and designate the remainder to provide flexi-access drawdown. The member can then take as little or as much of their flexi-access drawdown pot as they like. These drawdown payments are treated as income and will be subject to Income Tax at the member's marginal rate.

The whole of the amount designated for flexi-access drawdown is tested against their Lifetime Allowance at that point, regardless of the amount of income the member takes from their flexi-access drawdown pot

Prior to 6 April 2015, income drawdown could be taken as either flexible drawdown or capped drawdown (and before that as either unsecured pension or alternatively secured pension).

Unsecured pensions were only available to members under the age of 75 where instead of buying an annuity the member could call on their invested funds subject to an annual maximum limit. Alternatively Secured Pensions worked in a similar way except they were available to members from age 75.

Capped drawdown, like unsecured pensions, provided an individual with a means of taking variable pension benefits without setting up an annuity, subject to a maximum annual withdrawal limit. The maximum pension income that could be paid from a drawdown fund under capped drawdown was equal to 150% of GAD (Government Actuary's Department published rates being broadly equivalent to the annual amount of a level, single-life, lifetime annuity, without a guarantee period, which could be bought for the member on the date of calculation). For drawdown years prior to 27 March 2014, withdrawal was restricted to 120% GAD (those already in drawdown who had a review between 06 April 2011 and 25 March 2013 were restricted to 100% GAD). The maximum limit is reviewed at set intervals dependent on the age of the member. For example, capped drawdown was available to members over age 75 but the maximum withdrawal limit must be reviewed annually. Anybody who was receiving income under a capped drawdown arrangement on 6 April 2015 can choose whether to continue to receive their income under this arrangement or convert it to a new flexi-access drawdown arrangement.

Flexible drawdown was only available to members who are no longer active members of any pension scheme and who met a 'minimum income requirement' of £12,000 per annum. This included other scheme pensions or lifetime annuities in payment and state pension benefits. Providing they met the qualifying conditions, flexible drawdown enabled individuals to have full access to their drawdown fund without limit. The amount withdrawn was taxable as pension income. Prior to 27 March 2014, the minimum income requirement was £20,000 for flexible drawdown. Any flexible drawdown arrangements in place on 6 April 2015 were automatically converted to a new flexi-access drawdown arrangement.

These alternatives are considered in further detail in Retail Advice and Regulation.

11.52 Short Term Annuities

Short term annuities are annuities which pay a set income for a period of up to five years. They may be an attractive option for members wishing to ease themselves into retirement by a move to part time working. They may be used in conjunction with drawdown; this alternative is considered further in Retail Advice and Regulation.

11.5.3 Uncrystallised Funds Pension Lump Sums (UFPLS)

Uncrystallised Funds Pension Lump Sums were introduced on 6 April 2015 and gave members with DC benefits the opportunity to take their benefits either in one go, or in smaller chunks.

An UFPLS can be taken from any uncrystallised funds (funds that have not already been used to provide retirement benefits).

The first 25% of an UFPLS is paid tax free, and the remainder is subject to Income Tax at the member's marginal rate.

A member should carefully consider their tax position when deciding whether to take a UFPLS as taking a large lump sum in one go may move them into a higher tax bracket, whereas taking smaller lump sums over a number of years may keep them in a lower tax band thereby limiting their tax bill.

Although trust-based schemes may allow members to take an UFPLS as single lump sum (often to facilitate payment of a trivial commutation lump sum), many trust-based schemes do not offer the option of taking UFPLS as a series of lump sums due to the administrative complexities involved. If a scheme does not offer such a facility and a member wishes to use this method to provide income for a number of years, the member will need to transfer their funds out of the existing scheme to a specialist provider.

11.5.4 Full Encashment (Pensions Freedom)

Regardless of the size of the member's pension/pension pot, since April 2015 it has been possible for a member to encash the whole or part of his entitlement. However where the value exceeds £30,000 he must obtain authorised financial advice. We consider this option further in the Retirement Advice and Regulation manual.

11.6 PENSION COMMENCEMENT LUMP SUM (PCLS)

A PCLS of 25% of the value of the total benefits being taken from the scheme may be paid, providing the scheme rules allow.

For a DC arrangement this will typically be 25% of the value of the member retirement pot. It is a little bit more complicated for DB arrangements due to the way that such pensions are valued for LTA purposes.

Where the member's lump sum entitlement was greater than 25% as at 5 April 2006, this larger sum may be protected under the scheme rules. The Scheme Administrator is responsible for checking whether this protection applies.

Members who had a lump sum entitlement greater than £375,000 at 6 April 2006 may have applied for protection under transitional arrangements. Also, a member with Fixed Protection 2012 or 2014 could have a higher lump sum entitlement as the Lifetime Allowance for these members is the higher of £1.8m/£1.5m or the standard Lifetime Allowance respectively. The administrator should therefore check carefully any protections the member may have, when calculating their retirement benefits.

A PCLS is paid tax-free and can only be paid in conjunction with a pension entitlement, be that a Scheme Pension, Lifetime Annuity or Drawdown. It can be paid up to six months prior to and twelve months after the entitlement to the connected pension arises; payment outside of this window will be an unauthorised payment.

11.7 TRIVIAL COMMUTATION LUMP SUMS

Where a member's total pension benefits are small, it may be possible to commute the whole of a members benefit into a one off lump sum. This is known as trivial commutation. Prior to 6 April 2015, the Trivial Commutation Lump Sum payment could be paid in respect of all of a member's benefits in the scheme, both DB and DC. From 6 April 2015, as an Uncrystallised Fund Pension Lump Sum has been introduced (which allows members to fully commute an unlimited amount), the Trivial Commutation Lump Sum payment is now paid in respect of DB pension rights or scheme pensions in payment derived from DC pots.

The standard rule for trivial commutation is that it is only available where the value of the individual's pension rights from all registered schemes (including pensions in payment before this date) does not exceed £30,000, but there are some exceptions noted below. The 2014 Budget increased this figure from £18,000 for commutation payments made on or after 27 March 2014.

There are a number of conditions that must be met in order to pay a Trivial Commutation Lump Sum. A member may commute one or more of his pension arrangements at any time from the age of 55 (before 6 April 2015 the minimum age was 60 and prior to 6 April 2011 an upper age limit of 75 applied), provided that:

- All the DB benefits from the chosen scheme or schemes are commuted
- The member must have some LTA available
- If more than one arrangement is to be commuted, all commutations must take place within a twelve month period. This period is set by reference to the first trivial commutation lump sum payment.
- The value of all the member's pension rights cannot exceed £30,000 on the nominated date, which may be any date within three months of the start of the commutation period. The valuation methodology is set out in legislation; the actual amount paid to the member is determined by the scheme, and may be more or less than this
- The member can choose the nominated date, but if no date is chosen, a default nominated date is chosen by the trustees and is taken as the first day of the commutation period
- A Trivial Commutation Lump Sum must extinguish a member's entitlement to defined benefits under the scheme. Payment of any DC benefits is paid as an Uncrystallised Fund Pension Lump Sum. Any benefit commuted outside these circumstances will be treated as an unauthorised payment and suffer the relevant tax charges

Where benefits that are not in payment are trivially commuted, the first 25% of the payment will be tax free, with the balance taxed at the member's marginal rate. This 25% deduction is given to reflect that the member would generally have been entitled to a PCLS of 25% of the capital value of their benefit. If the member's benefits are in payment, the whole of the benefit is taxed. Trivial commutation payments have to be processed through a payroll system and taxed through the PAYE system.

From 1 December 2009, regulations came into force which widened the circumstances where trivial lump sums could be paid. These regulations, as updated, allow small lump sums of less than £10,000 to be paid, irrespective of the value of benefits elsewhere, provided that the remaining conditions for payment are met.This figure was increased from £2,000 for payments from 27 March 2014 as introduced by the 2014 Budget.A small lump sum extinguishes all of a member's benefits in the scheme (both DC and DB benefits). However, the scheme rules must allow this type of authorised payment to be paid.

11.8 EARLY RETIREMENT

Schemes will usually allow members to take their pension benefits before their Normal Retirement Date and the options available are normally similar to those described for retirement at NRD. There are however some additional considerations.

11.8.1 Voluntary Early Retirement or redundancy

Unless suffering from ill health a member cannot normally take pension benefits before age 55, known as the normal minimum pension age. Prior to 6 April 2010, the earliest a person could take retirement benefits was normally age 50.The Government have signalled their intention to increase minimum pension age so that the earliest date a person can normally take retirement benefits will be ten years before SPA (which is set to increase later this decade). Certain individuals may be able to take their benefits from age 50 if, on 6 April 2006, they had an unqualified right to take their benefits at that age (unqualified means that there are no conditions to be met in order for the benefits to come into payment, such as requiring employer or trustee consent) and that right existed in the schemes rules on 10 December 2003.

Under trust-based schemes, early retirement is usually subject to the consent of the scheme trustees and possibly also the employer. Under contract-based schemes, the procedure is normally much simpler since the member has direct contact with the provider. When benefits are paid early, generally the resulting pension benefits will be lower. This is to reflect the fact that the benefits are likely to be paid for a longer period and also for the reasons outlined in the following two paragraphs.

For a DB arrangement, the benefits are normally calculated in the same way as for retirement at NRD using pensionable service and salary up to the date of retirement (or earlier date of leaving service) but are then reduced (or 'discounted') for early retirement. Occasionally, e.g. on redundancy, early retirement pensions may be augmented (enhanced) by the employer with the consent of the trustees and subject to any funding costs being calculated and paid as necessary.

Where benefits are taken early from DC arrangements, the lower pension is usually as a result of the fact that the retirement pot will be lower (as fewer contributions will have been paid in and the pot will not have had as long to grow with investment returns) and because the cost of buying an annuity is generally more expensive the younger a member is.

11.8.2 Ill Health

If an employee is suffering ill health before NRD, he may be eligible for an ill health early retirement pension from the scheme. The scheme rules will define the conditions that must be met for this benefit to be provided and it may be subject to the trustees' consent.

DB ill health pensions are often augmented either as of right in accordance with the scheme rules, or at the discretion of the trustees and/or the employer.

For retirements due to ill health the HMRC requirements are that the Scheme Administrator has received evidence from a qualified medical practitioner (usually in the form of a written report) to the effect that the member is, and will continue to be, medically incapable (either physically or mentally) as a result of:

- Injury
- Sickness
- Disease, or
- Disability,

of continuing his current occupation and that the member has actually ceased to carry on their occupation.The minimum pension age requirements will then no longer apply.

The scheme rules may allow the pension to be reduced or suspended if the member makes a partial recovery or returns to full health. Where this is the case the member should be advised of this possibility at the point of retirement.

Serious ill-health

HMRC allow a member in 'serious ill health' to commute the whole of his pension, or take the entire fund under a DC scheme, at any age provided the pension is not already in payment. HMRC require this term to be interpreted strictly and narrowly. The Scheme Administrator must have received evidence from a registered medical practitioner that the member's life expectancy is less than one year. In addition, the payment must extinguish all of (and only) the member's entitlement to benefits under the arrangement, so any survivors' benefits must be moved to a separate arrangement before the lump sum is paid. A serious ill health lump sum cannot be paid if the member has already used up all of their LTA.

Serious ill health lump sums are tax-free if paid before age 75, provided the payment does not take the member over their LTA. Any amount in excess of the individual's available Lifetime Allowance is subject to the Lifetime Allowance charge.

For serious ill health lump sums paid after the member has reached age 75; if the payment is made on or after 16 September 2016 it is subject to Income Tax at the member's marginal rate. Payments made prior to 16 September 2016 were subject to the serious ill health lump charge of 45% (55% for lump sums paid before 6 April 2015).

It is important that, in determining whether a member qualifies for ill or serious ill health retirement, the provisions of the scheme rules are followed carefully and all HMRC requirements are met to avoid a decision being challenged.

Once it has been established that the relevant conditions for the particular type of ill health have been met, the administrator duties are as outlined above for the other retirement types.

11.9 LATE RETIREMENT

As well as giving members the option to take their benefits early, scheme rules may also allow members to defer taking their benefits after NRD. This may be because they are still working or otherwise do not need pension income at NRD.

For trust-based schemes (but not contract-based schemes), trustee and / or employer consent may be required for a member to defer taking their pension.

When the pension comes into payment, it is likely to be higher than it would have been had it been paid from NRD. If a member remains in employment after NRD, they may be allowed to continue to accrue additional pensionable service in a DB arrangement or continue to contribute to a DC arrangement. Even where additional accrual is not allowed, the pension that would have been payable at NRD is likely to be enhanced to reflect that fact that it will be paid for a shorter period of time.

Summary
This Chapter has detailed the various retirement options available and the implications for each of them.

Self Test Questions

- Distinguish between a scheme pension and a lifetime annuity
- List the options that may be available to a member when they reach NRD
- What is an uncrystallised funds pension lump sum (UFPLS) and what are the tax issues a member needs to consider if they decide to receive an UFPLS?
- How does a PCLS differ from an UFPLS?
- What are the conditions that must be met before a trivial commutation lump sum can be paid

INTRODUCTION

This Chapter sets out the types of benefits that might be payable on the death of a scheme member and how to comply with the necessary legislative requirements. Note that reference to spouse in this Chapter includes spouses under same sex marriage.

Note that most of these specific benefits apply to DB schemes. Under DC schemes death benefits will be determined by the asset values at death and will almost invariably be paid as a lump sum.

12.1 TYPES OF BENEFITS

12.1.1 Death in Service before NRD

Typically the benefits payable would be:

- a lump sum death benefit calculated as a multiple of the member's salary at date of death;
- a dependant's pension payable to a spouse/civil partner and also to children who meet any conditions specified in the scheme rules and by HMRC. In the case of a DC arrangement, the value of the member's retirement pot may be paid as a lump sum instead of providing a dependant's pension.

The lump sum will usually be payable under a discretionary trust. This is covered later in this Chapter under 'Exercise of Trustees' Discretion'.

A refund of the member's contributions may also be payable under a discretionary trust or may be payable automatically to the legal personal representatives. Where legal personal representatives are involved, the Grant of Probate or Grant of Letters of Administration should be obtained before payment is made.

12.1.2 Death in Service after NRD

In these circumstances the member would normally be treated the same as for death in service before NRD but this will depend on the scheme's rules. Usually therefore the benefits payable would be as described above.

12.1.3 Death in Early Retirement before NRD

Typically the benefits payable from DB arrangement would be:

- dependants' pensions payable to a spouse/civil partner and also possibly to qualifying children;
- a lump sum representing the balance of the pension that would have been paid to the member during a 'guarantee period' (usually five years from the retirement date).

The death benefits payable in respect of a DC arrangement will depend on the options selected by the member. For example: the death benefits included as part of the structure of the annuity purchased or the fund value if the member has selected benefits via the drawdown route.

12.1.4 Death in Retirement after NRD

Typically the benefits payable would be:

- dependants' pensions payable to a spouse/civil partner and also possibly to qualifying children;
- a lump sum representing the balance of the pension that would have been paid to the member during a 'guarantee period' (usually five years from the retirement date).

The death benefits payable in respect of a DC arrangement will depend on the options chosen when the member's annuity was purchased. For example: the death benefits included as part of the structure of the annuity purchased or the fund value if the member has selected benefits via the drawdown route.

12.15 Members who Die Following Flexible Retirement

Flexible retirement is where a member has drawn some, or all, of their accrued pension benefits but remain employed with the sponsoring employer. They may also continue to accrue additional pension benefits.

In these circumstances the benefits payable will depend on what the scheme rules provide for but may include both a death in service lump sum and a death after retirement lump sum. In addition, spouse's/civil partner's and children's pensions may also be payable.

The Retail Advice and Regulation Module discusses these options further.

12.16 Deferred Pensioners

Typically the benefits payable would be:

- dependants' pensions payable to a spouse/civil partner and possibly to qualifying children; and/or
- a refund of the member's own contributions.

12.2 LUMP SUM DEATH BENEFITS

The two main types of lump sum death benefit (known as relevant lump sum death benefits) that need to be distinguished are:

- a Defined Benefits Lump Sum Death Benefit, which is a lump sum paid from a DB arrangement on the death of a member. This includes lump sum death benefits based on multiples of earnings, service, or another factor. An example might be a lump sum that represents the balance of a guarantee on the death of a pensioner. The majority of the lump sum death benefits described will be defined benefits lump sum death benefits;
- an Uncrystallised Funds Lump Sum Death Benefit, which is a lump sum death benefit paid from a DC arrangement on the death of an active or deferred member.

Any lump sum death benefit paid will normally be deemed a 'relevant lump sum death benefit', unless the member has designated that they want the benefit paid as a taxable lump sum (known as a Pension Protection Lump Sum Death Benefit if paid from a DB arrangement). In addition, if the value of a dependant's pension is no more than £30,000, it is possible for it to be commuted entirely as a lump sum (known as a Trivial Commutation Lump Sum Death Benefit), provided the scheme rules allow this.

Before any death benefits are paid, the administrator (and insurer where applicable) will need sight of the original death certificate. If there is a spouse/civil partner and/or children to whom pensions are payable, their birth certificates (and marriage/civil partner registration certificate) and bank details will also be required.

In some schemes, discretion exists to pay a spouse's pension to a financially dependent partner. In these cases evidence needs to be gathered and the case referred to the trustees for a decision.

12.21 Payment of Lump Sum Death Benefits

As for other benefits, the payment of lump sum death benefits is governed by the scheme rules. In addition, under many schemes the trustees will have discretion as to who should receive the lump sum death benefit.

1222 Exercise of Trustees' Discretion

Lump sum death benefits are often paid to a recipient selected at the discretion of the trustees. The usual practice is as follows:

- The member will have been asked to nominate one or more beneficiaries by completing a nomination or expression of wish form, although the trustees are not obliged to comply with this nomination
- The trustees will determine the potential recipient(s) taking account of both the member's nomination form and also the member's personal circumstances at death
- The trustees usually make their decision as to which of the potential recipient(s) will receive a lump sum death benefit, and in what shares, at a full trustee meeting or through an appointed committee.

The benefit of paying lump sum death benefits under the trustees' discretionary powers is that it does not form part of the deceased's estate and therefore is not assessable for Inheritance Tax. Payment under trust also obviates the need to wait for Probate. The Expression of Wish form procedure is also used under contract-based DC schemes where in practice, the provider may be acting as trustee.

It is possible for an earmarking order under a divorce settlement to require that a specified percentage of any lump sum death benefit is to be paid automatically to the member's ex-spouse/civil partner. Allowance would need to be made for this before the trustees exercise their discretion over any remaining lump sum death benefit.

123 CHECKS REQUIRED BY HMRC

Payment of a relevant lump sum death benefit where the member dies before age 75 is a BCE and therefore the value of the lump sum must be tested against the member's available LTA. It is tax-free unless the member's available LTA is exceeded, in which case a Lifetime Allowance charge applies to the excess. Any tax charge is payable by the recipient of the lump sum, so the Scheme Administrator always pays any relevant lump sum death benefit gross.

The Scheme Administrator must inform the member's legal personal representatives of the amount and date of the payment of any lump sum together with the percentage of the standard LTA represented by the payment. This must be done within three months of the final lump sum being paid.

The legal personal representatives are responsible for testing the lump sum death benefit against the member's available LTA and reporting any excess amount to HMRC who will notify the recipient(s) of the lump sum of the Lifetime Allowance charge they must pay.

Relevant lump sum death benefits paid on the death of a member before age 75 must be paid within two years of the earlier of:

- the day on which the Scheme Administrator first knew of the member's death, or
- the day on which the Scheme Administrator could have first reasonably known about the member's death.

or they will be unauthorised payments.

A relevant lump sum death benefit can also be paid on the death of a member after age 75. This payment will not be a BCE but will be automatically taxed at 45% (55% if payment was made before 6 April 2015) and at the recipient's marginal rate if payment is made after 5 April 2016. This tax charge will be deducted by the scheme.

As an alternative to a relevant lump sum death benefit, schemes may allow members to opt for any lump sum death benefit payable on their death after retirement to be treated as a Pension Protection Lump Sum Death Benefit. It is not a BCE, however, so it is not tested against the member's available LTA. These lump sums may be beneficial for members who have already exceeded their available LTA as the pension scheme would deduct the tax when the lump sum is paid rather than the deceased member's personal representatives needing to arrange the payment of a lifetime allowance charge (at 55%) to HMRC.

The amount of tax payable, where a lump sum death benefit is subject to tax, depends on status of the recipient.

If the recipient is receiving the payment in their own right, then the payment is treated as pension income and will be taxed under PAYE.

If the recipient is receiving the payment in their capacity as a representative of another person or organisation, such as a trustee, a personal representative or a director / partner in a firm, then the payment will be subject to a special lump sum death benefit charge. This is a flat rate charge of 45% (55% for lump sums paid before 6 April 2015) which will be deducted by the scheme administrator and accounted for via the quarterly Accounting for Tax return.

For members who die after retirement, generally, any pension payments paid in respect of any period after death must be recovered otherwise the overpaid pension will become an unauthorised payment, unless the payments represent a continuing guarantee on the member's pension. This can be done by recalling the payment from BACS or requesting repayment from the estate. There are two exceptions to this requirement which apply where the Scheme Administrator was not aware of the member's death:

- the total overpaid does not exceed £250 net;
- the overpaid instalment(s) were paid within six months of the member's death.

If the member retired after 5 April 2006 and died after age 75, any dependant's pension payable must not exceed a prescribed limit (see PTM 072120). Any amount in excess of this limit would be an unauthorised payment. This limit was initially set for the 2016/17 tax year at £25,000 (or the level of the member's pension at the date of death, if higher). This limit will be increased each year by the higher of; 5%, CPI or RPI. Prior to this date the limit was the amount of member's pension paid in the previous twelve months, plus 5% of any PCLS paid on retirement. For the 2017/18 year, the limit has increased to £26,300.

Dependants' and spouses'/civil partners' pensions do not count towards the recipient's own LTA.

12.4 SPECIAL CONSIDERATIONS

12.4.1 Payment of Spouses'/Civil Partners' and Children's Pensions

- Spouses'/civil partners'/dependants' pensions are taxable under the PAYE system. Children's pensions should always be set up in the name of the child, even if they are being paid into the spouse's bank account, to ensure that the spouse is not taxed on the child's income.
- Scheme rules may specify a maximum age at which the payment of children's pensions ceases. It could be a fixed age e.g. 16 or 18 or depend on whether the child is still in full time education. HMRC requires children's pensions to cease at 23, except in special circumstances.
- Scheme rules may specify a reduction to the spouse's pension if the difference in the age between the deceased member and the spouse is more than a defined number of years.
- Scheme rules may include a definition of 'dependant' where the partners are not in a marriage, same sex marriage or registered civil partnership. Even if the rules do not, HMRC imposes conditions on who can be treated as a dependant of a member and so be entitled to a dependant's pension.
- Registered civil partners and widows of female members under a same sex marriage must, as a minimum, receive the same benefits as widowers in respect of contracted out benefits and the member's pensionable service from 5 December 2005. For benefits accrued before this date (except contracted out benefits) the scheme rules will dictate whether registered civil partners and same sex spouses are entitled to the same benefits as a spouse. However, students should note that, in July 2017, the Supreme Court issued a ruling in the case of Walker v Innospec stating that the exemption in the Equality Act 2010 which allowed schemes to restrict entitlement to survivors' pensions to benefits earned from 5 December 2005 was inconsistent with the relevant EU directive. The implication of this ruling is that schemes must provide equal survivors' benefits to civil partners and same sex spouses in respect of all pensionable service, that is, as per survivors of the opposite sex to the member.

12.42 Evidence of Continued Existence

To avoid making unauthorised payments and to prevent possible fraud, pension schemes should require members or dependants receiving a pension to prove continued existence and certificates to this effect should be requested at regular intervals, preferably certified by a professional person such as a doctor or solicitor.

Pension records can also be checked on a monthly or other basis against various databases such as the Bereavement Register as an additional measure to ensure that pensions do not continue to be paid where members have died.

12.43 Payments to the Estate

Even where the trustees have the power to decide who receives a lump sum death benefit under the trustees' discretionary powers, there are cases where the benefits have to be paid to the estate, for example where the trustees cannot identify a suitable recipient. Where payments are made to the estate of a deceased member under the trustees' discretionary powers, the payment is still excluded from the value of the estate for Inheritance Tax purposes.

In some cases a return of a member's contributions is automatically made to the personal representatives of the deceased member, on the basis that these are the member's own monies and should form part of the estate. Where the scheme rules require a payment to be made to the estate, that payment forms part of the estate for Inheritance Tax purposes.

Summary

This Chapter has covered the various options for death benefits and the associated requirements.

Self Test Questions

- Outline the process trustees normally follow before they exercise their discretion
- Describe the two main types of lump sum death benefits
- Describe the checks that are required by HMRC

INTRODUCTION

When determining the division of a couple's assets on divorce or on dissolution of a registered civil partnership, a Court must take the value of any pension benefits into account. If the Court decides to issue an order against any pension benefits, it can issue either a pension attachment order or a pension sharing order. Such orders can be made in respect of active, deferred or pensioner members.

In the following sections, any reference to an ex-spouse also includes a former registered civil partner.

13.1 BACKGROUND LEGISLATION

In general, Scottish law places a considerable emphasis on the concept of matrimonial property. This means that pre-marital, post-separation, gifted or inherited assets are likely to be out of the pot for sharing in Scotland.

Matters such as housing and income needs are not nearly as important in Scotland as they are in England. Whilst both Scottish law and English law share the clean-break principle; they have a very different interpretation of how to apply it, with Scotland applying it much more diligently than England.

Typically a spouse with substantial pre-marriage assets or assets that have been gifted or inherited will do better under Scottish law. Typically, a spouse seeking maintenance or housing will do better under English law. The financial advantage to be gained by being divorced in one country as opposed to another will vary from case to case, but in high value cases the advantage to be gained by being divorced in either Scotland or England can be considerable – millions of pounds in the really big cases.

The law relating to pensions and divorce has evolved in recent years. We cover some of the main changes below.

The Matrimonial Causes Act 1973
This Act gave the courts of England and Wales the power to resolve matrimonial assets and financial matters, including the value of retirement benefits of any pension arrangement. Courts could take pensions into account but they didn't have to, there was no provision for pension benefits to be passed from one party to another. Northern Ireland introduced a similar Act a few years later, in 1978.

The Family Law (Scotland) Act 1985
Either party to the marriage can apply to the court for an order to split the matrimonial property. The value of the pension benefits had to be offset as part of the financial settlement, although the ex-spouse had no direct access to the pension. There was no such provision in English law.

The Pensions Act 1995
This Act gave the courts in England, Wales, Scotland and Northern Ireland the power to make an "earmarking order", which meant that a percentage of the member's benefits could be earmarked for the spouse to receive in the future.

This can be used for divorces petitioned (i.e. started) on or after 1 July 1996 (England and Wales), 19 August 1996 (Scotland) or 10 August 1996 (Northern Ireland.)

The Act also made it compulsory for courts to take pension rights into account when determining the value of the matrimonial estate, effectively bringing England and Wales into line with Scotland.

The Welfare Reform and Pensions Act 1999

Pension funds can be the largest asset after the family home but previous Acts did not give the parties concerned a "clean break", so the Welfare Reform and Pensions Act 1999 introduced the option of pension sharing. It became effective for divorces occurring after 1 December 2000.

For the first time pension rights had to be treated as any other asset and could be transferred from one spouse to another on settlement. Both the husband and wife have separate, independent pensions.

The Civil Partnership Act 2004

With effect from December 2005, this Act allows same sex couples to enter into a civil partnership, with rights and responsibilities similar to the legal status of married couples. The Act introduced discretionary powers for a court on dissolution of a civil partnership, which include powers to make pension sharing and earmarking orders.

Marriage (Same Sex Couples) Act 2013

This Act was introduced for England and Wales on 17 July 2013 so that same sex couple have the same rights in law as other couples from March 2014.

13.2 DEALING WITH PENSIONS ON DIVORCE

There are three main ways of dealing with pension benefits on divorce:

- Offsetting;
- Pension Attachment Order/Earmarking; and
- Pension Sharing.

Offsetting is the simplest way to deal with the benefits, the total value of the pension benefits is offset against other assets such as a share in the family home. The use of this method does not vary between UK jurisdictions. It is however important to note that there are differences between English (applies to England and Wales) and Northern Ireland and Scottish law if either of the other two ways of dealing pension benefits on divorce are used – see below. Affected members should seek advice from an independent financial advisor and a solicitor.

Attachment/Earmarking Order

In this case, a part of the member's benefits are set aside for the spouse as directed by the Court. The amount is specified at the time of divorce and an Attachment/Earmarking Order is made against the member's benefits which takes effect when they come into payment.

Both pensions and lump sums (including death lump sums) can be earmarked and an Attachment Order made in England, Wales and Northern Ireland. In Scotland only lump sums can be earmarked and an Earmarking Order made.

Pension Sharing

This option applies to divorce proceedings from 1 December 2000 only and the member may not have a choice, as the court can order pension sharing to take place. The Pension Sharing Order (PSO) is sent to the scheme administrator who must implement it as directed, the administrator must also have a copy of the decree absolute.

Pension sharing separates the member's pension entitlement so there is a clean break and it offers greater flexibility than earmarking/ offsetting. It applies to all pension assets belonging to the couple however, if the member is divorcing under Scottish law then there are some differences, for example the assets are only those built up during the period of marriage/ civil partnership.

Orders and agreements in Scotland will normally be ineffective unless the person responsible for the pension arrangement receives copies of the relevant matrimonial documents within two months of the 'decree of divorce' or 'declarator of nullity.'

Summary

This Chapter has covered the different options for pensions on divorce.

Self Test Questions

- What is earmarking?
- How does pension sharing work?

The saying: "There are only two certainties in life – death and taxation", attributed to Benjamin Franklin, is well known. Tax can be defined as a compulsory payment levied (with certain exemptions) by a Government on income, assets and property to raise revenue for use by the State. In effect the taxes, which are collected by Her Majesty's Revenue and Customs (HMRC), become the income of the Government.

Personal taxation applies to individuals be they employees, self-employed (as sole proprietors or in partnership), pensioners, or investors holding stocks and shares or just a small building society "immediate access" deposit account.

Taxes under this grouping are Income Tax, Capital Gains Tax and Inheritance Tax and are usually assessed on an annual basis for income and capital sums received from 6 April in one year to 5 April in the next.

Income Tax is usually deducted at source from salary (but not the earnings of the self-employed), dividends and pensions: interest from April 2016 is now generally paid gross (but still subject to tax where relevant). All income is subject to self-assessment to correct any difference between the amount deducted and overall liability.

There may be a liability to Capital Gains Tax if any gains realised exceed the Annual Exempt Amount.

While Inheritance Tax is more usually encountered when a wealthy person has died, high net worth individuals may also find that they are liable to Inheritance Tax charges during their lifetimes.

National Insurance (NI), though not strictly a tax, is another source of revenue for the Government. All individuals aged between 16 and State Pension Age who are employed or self-employed are liable to make NI contributions providing they earn more than prescribed levels of income. For employees there is also an upper earnings limit, above which they are only liable to make NI contributions of 2% of earnings (from the 2011/12 tax year – previously this figure was 1%).

In addition to the contributions made by an employee, his employer must also make NI contributions. There is no upper earnings limit or upper age limit for employer's NI contributions.

Self-employed people pay NI contributions at a flat weekly rate together with a percentage of profits earned in line with prescribed levels of income.

The above taxes, particularly those related directly to income are in general applied on a progressive basis i.e. the rates become higher the higher income becomes. This Part also considers other taxes which the State uses to raise income, such as Value Added Tax. The latter is an example of an indirect tax which does not take account of a person's ability to pay. Indirect taxes are generally considered regressive and it is often argued that these hit the poorest members of society much harder than those with significant incomes.

Tax Law and Practice

Prior to more detailed coverage of these taxes we will outline the nature and variety of tax law in the UK.

UK tax law is established in three distinct ways:

- primary legislation embodied in Statute (the Taxes Acts);
- secondary legislation (regulations) in the form of Statutory Instruments and orders made under powers contained in primary legislation; and
- case law which mainly consists of interpretation of legislation arising in the Courts and which also extends to judicial review of relevant legal concepts that are not defined in legislation, such as residence and domicile.
  Note: The Judiciary do not have the power to override primary legislation: primary legislation remains firmly within the control of Parliament.

Income Tax is mainly governed by the Statutes mentioned below (and secondary legislation arising therefrom):

- The Income Tax Act (ITA) 2007 which came into force on 6 April 2007;
- The Income Tax (Trading and Other Income) Act 2005 (ITTOIA), which came into force on 6 April 2005;
- The Income Tax (Earnings and Pensions) Act 2003 (ITEPA), which came into force on 6 April 2003;
- some provisions of the Income and Corporation Taxes Act 1988 (ICTA) that still apply to Income Tax.

The ITA, ITEPA and ITTOIA, *inter alia*, all sprang from the long-running (since 1997) tax law Rewrite Project which aims to make primary tax legislation clearer and easier to use, without changing the law. It was described as "The Path to Tax Simplification" at the consultation stage in 1996.

Other main taxes which impact directly on individuals include:

- Inheritance Tax is governed by the Inheritance Tax Act 1984;
- Capital Gains Tax by the Taxation of Chargeable Gains Act 1992; and
- Value Added Tax by the VAT Act 1984.

Corporation Tax (CT) is still mainly governed by ICTA but the CT legislation is being rewritten and the first of five new CT Acts, the Corporation Tax Act 2009 came into force on 1 April 2009 and, where it affects Income Tax, applies to 2009/10 and subsequent tax years. A further CT Act received the Royal Assent in March 2010. Note that Corporation Tax is a recent introduction: prior to 1 April 1965 the taxation of companies was just another cog in the Income Tax collection machine.

HMRC's powers and taxpayers' responsibilities are mainly governed by the Taxes Management Act 1970 and regulations made under that Act.

The Legislative Process

The main source of new primary legislation, as distinct from the rewrite process and other consolidations, is the annual Finance Act. The annual Finance Act renews the authority necessary to raise Income Tax.

Customarily the Finance Bill:

- was introduced in the week following the Budget in March. This changed to Autumn in 2017. A Spring Statement replaces the March Budget and this is expected to contain limited steps to respond to the Spring forecast from the Office for Budgetary Responsibility;
- passes through the customary stages of debate in Parliament;
- receives Royal Assent and passes into law as the Finance Act in the last week of the parliamentary session, usually in the third or fourth week of July. From 2018 this changes to the Spring.

Where the Budget contains announcements of counter-action measures dealing with tax avoidance such measures take effect as from the date on which they are first announced. Where legislation is amended in the course of the Bill's progress through Parliament the amendments will normally still apply as from 6 April or the date on which they were originally intended to apply unless the amendments impose an additional tax burden, in which case they will take effect from the date when they are introduced or debated.

Where appropriate, information for this manual has been obtained from Government publications.This means that sections of this Chapter in confirming tax details, have been written from the Second Person perspective rather than the Third Person.

INTRODUCTION

Income Tax is unlike other taxes in that it is an annual tax which must be renewed by Parliament every year. The Office for Budgetary Responsibility estimated 2017/18 taxes on different forms of personal income to provide the biggest source of revenue for Government: £174.9 billion, 23.5%t of all receipts, equivalent to £6,200 per household and 8.6% of national income.

Income Tax was first levied in 1799 as a temporary measure to help pay for the Napoleonic Wars. The originating statute of 1799 was described as "an act for granting to his majesty an aid and contribution for the prosecution of the war". The top rate of tax was 10%. The measure was repealed after just three years when a lull in hostilities allowed this. But a precedent had been set and by 1806 had been reintroduced, persisting until after the Battle of Waterloo. It reappeared in 1842 and has remained with us since.

It was perhaps Gladstone's four-hour long Budget speech on 18 April 1853 which finally melded Income Tax into established Government financing. Full of data, a convincing argument was put forward for using Income Tax rather than higher indirect taxes, such as excise duties (similar to VAT now) on, for example, candles, beer, soap, salt and horses or direct taxes such as a land tax on property owners or even a window tax where house owners paid a duty based on number of windows in their dwellings.

Extracts from Gladstone's speech follow below: students will not be examined on these but they do show that Budgets over 150 years ago are little changed in principle from Budgets today and that the balance which successive Governments need to strike between income and expenditure and the way they justify the steps they are proposing, changes little. The same principles will apply in next year's Budget and subsequent years; there will always be adjustments and anyone advising clients will need to bear these adjustments in mind and determine how they affect, if at all, their clients.

> "I now approach a very difficult portion of the task that I have to perform—the discussion of the Income Tax. The first question that this Committee has to consider is, whether or not it will make efforts to part with the income tax at once … it would be possible for you at once to part with the income tax. But Her Majesty's Government do not recommend such a course to the Committee. They do not recommend it because they believe, in the first place, that such a system would, upon the whole, be far more unequal and cause greater dissatisfaction than the income tax; they believe, likewise, that it would arrest other beneficial reforms of taxation; and they believe that it would raise that difficult question in regard to the taxation of the public funds of this country in a form the most inconvenient.
>
> "Sir, it was in the crisis of the revolutionary war that, when Mr. Pitt found the resources of taxation were failing under him, his mind fell back upon the conception of the income tax; and, when he proposed it to Parliament, that great man, possessed with his great idea, raised his eloquence to an unusual height and power.
>
> "From 1793 to 1798, a period of six years, there was no income tax; from 1799 to 1802, there was an income tax; but the provisions of the law made it far less effective, in proportion to its rate, than it now is; and from 1806 to 1815, a period of eleven years, you had the income tax in its full force. Now, every one of us is aware of the enormous weight and enormous mischief that have been entailed upon this country by the accumulation of our debt; but it is not too much to say, that it is demonstrated by the figures, that our debt need not at this moment to have existed, if there had been the resolution to submit to the income tax at an earlier period."

Gladstone concludes:
"Sir, I scarcely dare to look at the clock, reminding me, as it must, how long, how shamelessly I have trespassed on the time of the Committee. … These are the proposals of the Government. They may be approved, or they may be condemned, but I have at least this full and undoubting confidence, that it will on all hands be admitted, that we have not sought to evade the difficulties of our position—that we have not concealed those difficulties either from ourselves or from others; that we have not attempted to counteract them by narrow or flimsy expedients; … we have endeavoured, in the plans we have now submitted to you, to make the path of our successors in future years not more arduous, but more easy; and I may be permitted to add, that while we have sought to do justice, by the changes we propose in taxation, to intelligence and skill, as compared with property —while we have sought to do justice to the great labouring community of England by further extending their relief from indirect taxation, we have not been guided by any desire to put one class against another; we have felt we should best maintain our own honour, that we should best meet the views of Parliament, and best promote the interests of the country, by declining to draw any invidious distinction between class and class, by adopting it to ourselves as a sacred aim, to diffuse and distribute—burden if we must; benefit if we may—with equal and impartial hand; and we have the consolation of believing that by proposals such as these we contribute, as far as in us lies, not only to develop the material resources of the country, but to knit the hearts of the various classes of this great nation yet more closely than heretofore to that Throne and to those institutions under which it is their happiness to live."

The annual Finance Act sets the current rates of tax in line with Government policy. The definition of income for tax purposes is not precise. The statutory definitions refer to income, profits or gains at various times. This is necessary as income is not easy to contain in a single definition. Income is defined for tax purposes depending on its source. Sources of income were previously defined in the Income Tax Schedules (see section 1.3), which formed the classification of income sources used both for Income Tax and Corporation Tax. The old Income Tax schedules have been replaced by statutory provisions contained in ITA, ITEPA and ITTOIA.

The latest of the three Acts, ITA, states at section 3 that Income Tax is charged under:
(a) Part 2 of ITEPA 2003 (employment income),
(b) Part 9 of ITEPA 2003 (pension income),
(c) Part 10 of ITEPA 2003 (social security income),
(d) Part 2 of ITTOIA 2005 (trading income),
(e) Part 3 of ITTOIA 2005 (property income),
(f) Part 4 of ITTOIA 2005 (savings and investment income), and
(g) Part 5 of ITTOIA 2005 (miscellaneous income).

The same section continues: Income Tax is also charged under other provisions, including:
(a) Chapter 5 of Part 4 of FA 2004 (registered pension schemes: tax charges),
(b) section 7 of F(No.2)A 2005 (social security pension lump sums),
(c) Part 10 of this Act (special rules about charitable trusts etc),
(d) Chapter 2 of Part 12 of this Act (accrued income profits), and
(e) Part 13 of this Act (tax avoidance).

The above indicates the far-reaching scope which the tax authorities have been given for collecting tax on all types of income. Further provisions in ITA set out allowances, reliefs and the way the deductions are made, the effect of which is summarised in the following sections of this Manual.

ITA refers to the earlier legislation and these Acts are similarly far-reaching in their effect.

ITEPA s7 defines elements of income for the purposes of tax collection: "employment income", "general earnings" and "specific employment income". These are, briefly (the Act gives further detail):
"Employment income" means
(a) earnings,
(b) any amount treated as earnings
(c) any amount which counts as employment income

"General earnings" means
(a) earnings
(b) any amount treated as earnings excluding any exempt income.

"Specific employment income" means any amount which counts as employment income excluding any exempt income.

ITEPA at s10 states: Taxable earnings from an employment in a tax year are to be determined in accordance with
(a) Chapter 4 of this Part (rules applying to employees resident, ordinarily resident and domiciled in the UK), or
(b) Chapter 5 of this Part (rules applying to employees resident, ordinarily resident or domiciled outside the UK).

ITTOIA simply states at section 5 that Income Tax is charged on the profits of a trade, profession or vocation, while s6 expands this to include
(1) Profits of a trade arising to a UK resident are chargeable to tax under this Chapter wherever the trade is carried on.
(2) Profits of a trade arising to a non-UK resident are chargeable to tax under this Chapter only if they arise—
  (a) from a trade carried on wholly in the United Kingdom, or
  (b) in the case of a trade carried on partly in the United Kingdom and partly elsewhere, from the part of the trade carried on in the United Kingdom.
(3) This section applies to professions and vocations as it applies to trades.

It is not necessary for the student to know which section of ITA, ITEPA and ITTOIA covers which tax or which provisions, but as a future adviser the student needs to remember this far-reaching scope (and where to look if any further detail is required) and ensure that advice given allows for these components and any modifications thereto. The following sections of this Study Manual provide a workable summary.

1.1 MEANING OF INCOME

A distinction is made by HMRC between income that is regarded as earned and unearned for tax purposes. This is important since earned income broadly forms the basis for eligibility for tax relief on pension contributions (and historically a higher tax rate applied to unearned income).

Earned income falls into three main categories.
- Income arising both directly and indirectly from employment. This includes: payment made for service; inducement payments to take up employment; and compensation for loss of office.
- Earnings by an individual from a trade, profession or vocation whether carried on alone or in partnership are all taxed as self-employed earnings. What amounts to income is broadly based on accounting principles which draw a distinction between capital and revenue but those principles are often overridden by specific tax rules that may disallow expenditure (e.g. entertaining) or determine the timing of allowances (e.g. the statutory system of capital allowances that replace depreciation rules).

- Most pensions income, State, company and personal, including State pensions (Basic and earnings-related), public and private pensions, foreign pensions, annuities and drawdown payments to the holders of personal pensions. In addition State unemployment benefits (Jobseeker's Allowance etc.), Carer's Allowance, Widow's Pension, Statutory Sick Pay, Maternity Pay, Adoption Pay and Paternity Pay are classed as income for tax purposes. (Parts 9 and 10 of ITEPA list those income sources which give rise to a tax liability.)

Note however, that while pension income and certain benefits are taxed as earned income they do not qualify as income on which further pensions contributions can be based. Part 1 of this study manual has considered tax relief on contributions in further detail.

Unearned income broadly encompasses all investment income, including dividends, rental income and chargeable gains on life insurance policies. It includes income from business-like activities that involve some management involvement but fall short of amounting fully to a trade: the prime example of this being property income where the main source of income is the letting of the property as distinct from the provision of services. Annual interest received, including interest payments from building societies and banks is perhaps the most common type of unearned income.

Exceptions to liability to UK Income Tax arise with certain types of income. Exceptions include certain State benefits (see below), interest from certain National Savings benefits, interest from ISAs, income which HMRC are prepared to regard as return of capital (for example the Capital Content in an annuity purchased from personal savings or the "income" up to 5% of purchase amount taken from a life assurance bond), Premium Bond prizes, the first £7,500 (which increased from £4,250 – the unchanged allowance for 18 years – on 6 April 2016) of rent paid by a lodger and lottery and gambling winnings (but with the latter, up-front Lottery or Gaming Duty applies).

The following State benefits are not taxable (Source EIM76100 (published 29 February 2016, updated 4 October 2017) – Social Security benefits: list of non-taxable Social Security benefits):

- Attendance Allowance
- Back to Work Bonus
- Bereavement Payment, replaced Widow's Payment from 9 April 2001
- Child Benefit
- Child's Special Allowance
- Child Tax Credit
- Cold Weather Payments, see also Winter Fuel payment
- Council Tax Benefit, administered by local authorities
- Constant Attendance Allowance, see industrial disablement benefit below
- Disability Living Allowance
- Income related Employment and Support Allowance
- Exceptionally Severe Disablement Allowance, see industrial disablement benefit below
- Guardian's Allowance
- Housing Benefit, administered by local authorities
- Incapacity Benefit for first 28 weeks of entitlement, taxable thereafter
- Income Support, certain payments
- Industrial Injuries Benefit, a general term covering industrial injuries pension, reduced earnings allowance, retirement allowance, constant attendance allowance and exceptionally severe disablement allowance
- Invalidity Benefit, replaced by Incapacity benefit from April 1995 but still payable where invalidity commenced before April 1995.
- In-work credit
- In-work emergency discretion fund payment
- In-work emergency fund payment
- Maternity Allowance

- Payments out of the Social Fund to people on a low income to help with maternity expenses, funeral costs, financial crises and as community care grants. The fund also makes interest-free loans.
- Pensioner's Christmas Bonus
- State Pension credit
- Reduced Earnings Allowance, see industrial disablement benefit above
- Retirement Allowance, see industrial disablement benefit above
- Return to work credit, including the self-employment credit
- Severe Disablement Allowance
- Universal Credit
- War Widow's pension
- Winter Fuel payment
- Working Tax Credit.

1.2 UK RESIDENCE

A person's residence status needs to be established to determine which UK tax rules apply to that individual's worldwide income. An individual who is UK resident in the tax year will in most cases be liable to Income Tax on all income irrespective of whether that income comes from within or from outside the UK. Briefly, anyone who is present in the UK for 183 days or more in the tax year is UK-resident.

We consider the position of non-UK residents in section 1.6 of this Chapter. But before that, we will look at the operation of the UK tax system for UK residents.

1.3 THE CHARGE TO INCOME TAX

ITA, as referred to in the Introduction to this Chapter, contains the basic provisions of Income Tax, such as the charge to Income Tax, tax rates, how a person's Income Tax liability is calculated, personal reliefs and definitions of the terms used for Income Tax purposes. It deals with various specific tax reliefs, including reliefs for losses, Enterprise Investment Schemes, Venture Capital Trusts, Community Investment Tax Relief, interest paid, Gift Aid and gifts of assets to charities. It also covers settlements and trusts, tax avoidance and the deduction of tax at source.

ITTOIA brings together the Income Tax charging and calculation rules for the different sorts of income (both from UK and foreign sources) such as trading income, savings and investment income etc. It replaces the old Income Tax schedules A, B, C, D, E and F

ITEPA is the primary tax legislation relating to income from employment, pensions and social security.

1.4 DEDUCTIONS FROM INCOME

Certain expense payments are allowed to be deducted from the income charged to tax under ITA, ITEPA or ITTOIA. This has the effect of reducing the tax liability. For employees subject to ITEPA, the deductible expenses are very restricted. Self-employed individuals chargeable under ITTOIA can claim a wider range of allowable deductions.

It is important to remember the contrast between the conditions for deductibility of expenses under ITTOIA (which need to be wholly and exclusively for the purposes of the business or otherwise meet statutory criteria specific to the deduction concerned, e.g. for interest paid) and ITEPA expenses (which need to be wholly, exclusively and necessarily incurred in the course of the employment).

1.5 ESTABLISHING THE TAX LIABILITY OF AN INDIVIDUAL

When working out an individual's tax liability it is necessary to identify the type of the income and, hence, the legislation under which it falls to be taxed. This determines the reliefs available.

All income chargeable to Income Tax is then added together to give an individual's "total income". Expenses and reliefs available under the ITA, ITEPA or ITTOIA are deducted. Each individual has an annual Personal Allowance that reduces the amount of income on which tax is paid: the Personal Allowance is deducted from the total income. The resulting figure is the individual's "taxable income".

In any tax year, income is divided into bands to which different tax rates apply. Rates are set in each year's Finance Act. These are often a key factor in the economy and are announced in the preceding Budget.

The main Income Tax bands that apply to taxable income for 2019/20 and the Income Tax rates that apply to each band are as follows:

Basic rate 20% on taxable income between £0 and £37,500
Higher rate 40% on taxable income between £37,501 and £150,000
Additional rate 45% on taxable income above £150,000 (prior to the 2013/14 tax year the additional rate was set at 50%)

The order that income is taxed is as follows (this order can have the effect, inter alia, of negating the Savings Starting Rate Limit which is considered below):

1. Salary/pensions
2. Savings interest
3. Offshore bond gains
4. Dividend income
5. Capital Gains.

Establishing an individual's tax liability is an important element in giving advice. Unless the adviser is providing limited advice (regarding a specific investment perhaps) and this advice is clearly restricted to giving limited advice only, the adviser needs to understand and apply the underlying tax rules to determine whether or not his client is arranging his financial affairs correctly. Once an adviser has established a client's wider objectives (the Retail Advice and Regulation manual analyses the criteria which need to be considered) then these objectives need to be delivered to the client in a way which allows for effective tax planning taking into account the features of the tax structure which might apply. This current section identifies the basic initial strategy which should be followed while the subsequent sections in this Chapter and other parts of the DRRA course refer where relevant to tax planning tactics.

1.5.1 Personal Allowances

Personal Allowance

The amount of an individual's Personal Allowance depends on his total income in the tax year. The standard level of Personal Allowance is £12,500 for 2019/20.

The Personal Allowance also used to depend on a person's age but from April 2013, age-related Allowances started to be phased out. As a result, higher Allowances for people born before 6 April 1948 have been brought into line with the increased standard Personal Allowance, with effect from April 2016. (If any adviser needs to look at this aspect, the key dates are for people born before 6 April 1938 as well as 6 April 1948.)

From the 2010/11 tax year the income limit was introduced. Taxpayers whose "adjusted net income" exceeds £100,000 lose all or part of their Personal Allowance. The £100,000 ceiling has not changed since its introduction. "Adjusted net income" is "total income" adjusted to take account of certain deductible allowances and reliefs such as trading losses, donations made to charities through Gift Aid and some pension contributions.

Where an individual has adjusted net income of over £100,000, his Personal Allowance will be reduced by £1 for every £2 earned over the £100,000 limit. If the adjusted income is large enough (above £125,000 for 2019/20), an individual's Personal Allowance will be reduced to nil. A person with this level of earnings has a marginal tax rate of 60% so advisers need to be aware of this and, probably, give advice to avoid it or mitigate its effect. (A further marginal rate trap applies for those individuals who receive the Married Couple's Allowance – this is considered below.)

In addition to Personal Allowances, individuals might also be entitled to a Blind Person's Allowance, a Married Couple's Allowance, Marriage Allowance, Maintenance Payments relief, Transferable Married Couple's Allowance, Dividend Allowance or a Personal Savings Allowance (the last two started in April 2016).

Blind Person's Allowance

If an individual is blind and on a local authority register of blind persons, or in Scotland and Northern Ireland an individual is unable to perform any work for which eyesight is essential, he can claim the Blind Person's Allowance. This is added to his Personal Allowance. For low earners, or those that do not pay any tax, this allowance may be transferred to a spouse or civil partner. The Blind Person's Allowance for 2019/20 is £2,450.

Married Couple's Allowance

An individual might be able to claim a Married Couple's Allowance if:

- he/she is married or in a civil partnership
- he/she is a taxpayer
- he/she or her/his spouse or civil partner were born before 6 April 1935.

For couples married before 5 December 2005 the husband can claim the Married Couple's Allowance and the amount received will depend on the husband's income. For couples married or entering into a civil partnership on or after 5 December 2005 the person with the higher income can claim the allowance. The amount received depends on the income of the spouse or civil partner with the higher income.

The maximum Married Couple's Allowance is £8,915 and the minimum amount is £3,450 for the 2019/20 tax year (even for persons earning in excess of £100,000). The individual receives tax relief at 10% of the Allowance amount, i.e. between £345.00 and £891.50 in 2019/20. The Married Couple's Allowance was restricted from April 2000 to couples (extended to Civil Partnerships from December 2005 retaining age restriction) where at least one spouse was born before 6 April 1935 (i.e. 65 attained in April 2000).

Where the individual's income is over £29,600 in 2019/20, HMRC will reduce the Married Couple's Allowance. The amount of the reduction is worked out as follows:

- HMRC deducts half of the excess income above £29,600 from the individual's Personal Allowance of £12,500.
- The resulting figure is then adjusted to give the equivalent 10% tax relief which is then deducted from the Married Couple's Allowance subject to the £345 minimum MCA amount remaining available

.

Example
In the 2019/20 tax year an individual born on 2 May 1934 who is entitled to Married Couple's Allowance has an income of £31,600. The individual's Allowance is calculated as follows:

Income above the income limit	£31,600 – £29,600 = £2,000
Reduction to Personal Allowance	£2,000/2 = £1,000

Reduction to be offset against Married Couple's Allowance is £1,000

Married Couple's Allowance entitlement in 2019/20 is £8,915, which is reduced as follows: £8,915 – £1,000 = £7,915.

For this individual, therefore, the Married Couple's Allowance adjustment is £791.50 (10% of £7,915), which is the amount by which HMRC will reduce the individual's tax bill.

Where the individual's income is low, he can transfer any unused allowance to his spouse or civil partner. It is also possible for couples to decide to share the allowance or transfer the whole of the allowance to the other spouse or civil partner before the start of the tax year.

Advisers will need to be aware of clients (aged at least 84 in 2019/20) who could lose part of their MCA if, for example, new drawdown income takes them into the 30% marginal rate which would apply.

Maintenance Payments Relief
An individual can claim for legally enforceable maintenance payments relief if all of the following apply:

- he/she or his/her ex-spouse or former civil partner was born before 6 April 1935
- they are separated or divorced or the civil partnership has been dissolved
- he/she is making payments under a Court Order
- the payments are for the maintenance of his/her ex-spouse or former civil partner (provided they are not remarried or in a civil partnership) or for children under the age of 21
- the ex-spouse or former civil partner is not remarried or in a new civil partnership.

For the 2019/20 tax year Maintenance Payments Relief can reduce an individual's tax bill by 10% of the maintenance payments made in the year up to a limit of £3,450. Where maintenance payments are less than £3,450 in 2019/20, the relief will be calculated by using the actual amount of maintenance paid. For example a payment of £2,000 to a qualifying ex-spouse would generate an extra £200 in tax relief, 10% of £2,000, £200 being deducted from the taxpayer's tax bill. (The maximum relief is currently linked to the minimum amount of Married Couple's Allowance.)

This relief cannot be claimed for any voluntary payments made for a child, ex-spouse or former civil partner.

Marriage Allowance (Transferable Tax Allowance for Married Couples and Civil Partners)
Presaged in the 2013 Autumn Statement and introduced in the 2014 Spring Budget, this Allowance permits a spouse or civil partner who is not liable to Income Tax above the basic rate to transfer 10% of their Personal Allowance to their spouse/civil partner, provided that the recipient of the transfer is not liable to Income Tax above the basic rate. Those claiming the Married Couple's Allowance are not eligible. The effect of this measure can save couples tax of up to £250 (from 6 April 2019, being 20% basic rate tax on £1,250). This Allowance first applied from 6 April 2015.

Dividend Allowance

From April 2016 a new tax-free Dividend Allowance replaced the Dividend Tax Credit.

The Dividend Allowance means that the first £5,000 of dividend income is tax-free, no matter what non-dividend income a person has. This allowance is available to anyone who has dividend income. The Dividend Allowance was reduced to £2,000 from April 2018.

Rates of dividend tax payable on any dividends over the Dividend Allowance are at the following rates:

- 7.5% on dividend income within the basic rate band
- 32.5% on dividend income within the higher rate band
- 38.1% on dividend income within the additional rate band.

Note that the way in which the Dividend Allowance works means that in effect will be part of the Basic Rate band.

Personal Savings Allowance

The 2014 Budget announced that from April 2015 tax on interest where taxable income was less than £15,600 would not be payable. The Government have since extended this so that since April 2016, the majority of people do not have to pay tax on the first £1,000 (£500 for higher rate taxpayers, £0 for additional rate taxpayers) of interest they earn on their savings. This has been achieved with the introduction of a new £1,000 Personal Savings Allowance on 6 April 2016. Further, since 6 April 2016 all Bank and Building Society interest has been payable gross and since the majority of basic rate taxpayers do not have interest income exceeding £1,000, most tax payers receive up to £200 a year tax saving on their savings interest. (Until April 2016 basic rate tax was normally deducted so that interest was paid net to investors. Investors who had no tax liability could elect for interest to be paid gross using form R85.)

The Personal Savings Allowance means from April 2019, allowing also for the £5,000 Starting Rate Limit for Savings, no tax is payable on interest if a person's taxable income is less than £17,500 **and** that income includes £5,000 savings income.

To be eligible for the additional £1,000 tax-free Personal Savings Allowance, taxable income needs to be less than £46,350 a year.

To be eligible for the additional £500 tax-free Personal Savings Allowance, taxable income needs to be between £43,500 and £150,000 a year.

Non-savings income above the Personal Allowance is deducted from the Starting Rate Limit for Savings, before any savings income is considered (refer to 1.5 above for the order in which different types of income are taxed).

Note that the way in which the Personal Savings Allowance works means that it is part of the Basic Rate band.

1.5.2 Benefits in Kind

Benefits in kind are perks provided by an employer to an employee as part of the overall remuneration package. Benefits are treated as employment income by ITEPA supplemented by additional provisions set out in the Benefits Code, HMRC's Tax Guide to Expenses and Benefits. The Benefits Code generally seeks to ensure that recipients of benefits in kind are taxed on the full value of any benefit received but in certain cases, in particular "company" vehicles and fuel provided for private use, the levels of benefit are deliberately manipulated to provide incentives to use less expensive, less polluting vehicles. HMRC's Employment Income Manual gives the detail of treatment of perks including where there are dispensations taking such perks out of any charge to tax.

The treatment of benefits in kind for National Insurance purposes has varied over time but has followed a process of convergence with Income Tax so that the majority of benefits are now subject to a charge. The extent to which a particular benefit in kind is taxable depends on the status (including earnings) of the employee or the director, the type of benefit and the amount of employee contribution (if any) towards the benefit.

An employee who forgoes entitlement to cash in favour of a benefit, such as medical insurance or critical illness cover will be taxed on the higher of the amount of cash forgone or the value of that benefit.

Not all benefits are subject to tax in this way. Pensions, life assurance and additional holiday entitlement (not the holiday pay itself) are examples. It is possible to change employment terms so that the employee's contractual entitlement to cash payment is reduced and replaced by a benefit in kind. This is known as "Salary Sacrifice" and may be efficient in saving tax, or at least NIC, but requires the terms of employment to be legally amended: we look at this further in the following sub-section. However, Salary Sacrifice arrangements caught the attention of the Treasury and certain changes, spinning off from this concern, have been introduced: the tapering of the Annual Allowance for higher earners is an example.

Until April 2016, the "benefit in kind" rules applied only to employees earning over £8,500 (and to directors earning less than £8,500 if owning 5% of shares). Historically, this used to be referred to as the "higher paid" earners tax charge but the amount had not been changed since 1979. Given the increase of the Personal Allowance over the decades from when the "higher paid" limit was first introduced, employees earning less than £8,500 a year are not liable to pay Income Tax (unless they have other employment or investment income). This £8,500 floor was therefore abolished from 6 April 2016 and consequently all expenses and benefits (except business expenses) will normally need to be reported. From 6 April 2016 Class 1A NICs will also be payable on all benefits in kind, regardless of an employee's earnings.

At the discretion of the local tax inspector, some employers have negotiated the right to tax benefits "at source" that is via the payroll. This means that they do not have to deal with the administration effort required to complete P11Ds. If benefits are taxed at source employees are less likely to receive tax assessments when they complete their tax returns after the end of the tax year.

Salary Sacrifice

A "salary sacrifice" is an arrangement where an employee waives their contractual entitlement to part of their cash pay, in exchange for a non cash benefit provided by their employer. The salary sacrifice is achieved by varying the employee's contract of employment and as such falls under employment law rather than tax law.

The most common salary sacrifice arrangement is where the employer pays a corresponding amount into a registered pension scheme instead of member contributions. The payment is thus an employer contribution to the scheme, which does not attract National Insurance Contributions (NICs). Salary sacrifice can also be used in relation to other benefits such as:

- childcare vouchers;
- workplace nurseries;
- loaned cycles and cyclists' safety equipment
- ultra-low emission cars.

In a salary sacrifice arrangement, employers pay a reduced level of salary to employees, but also pay an equivalent amount to provide the benefit selected. Employees see a reduction in their gross annual salary equal to the amount of salary sacrificed. This means that they and their employer pay NICs on a lower salary. Saving NICs is often the main driver for salary sacrifice and sometimes an employer will rebate part of their NICs savings to additional employee benefits to persuade their workforce to accept the new salary sacrifice arrangement.

In the Autumn Statement 2016 however, the Chancellor announced his intention both to tax and apply National Insurance Contributions to the value of all salary sacrifice benefits (the above listed items being the main exemptions) from April 2017 which means significant reappraisal of salary sacrifice arrangements including the provision of private medical care (with possible implications for further pressures on the National Health Service).

The effect that adopting salary sacrifice can have, where salary sacrifice still remains effective for tax and NIC savings, on the amount of NICs payable is shown in the Example below.
The employee NIC rates ("primary" NICs) for 2019/20 are:

- 12% on earnings between £166 and £962 per week
- 2% on earnings above £962 per week.

The employer NIC rate ("secondary" NICs) is:

- 13.8% on earnings above £166 per week (the primary and secondary thresholds are currently the same but they have been marginally different in 2000/01 when the Earnings Threshold was first introduced and again in 2011/12 to 2013/14 inclusive; they were the same in 2014/15 but differed marginally in 2015/16 and 2016/17).

Example
An individual earning £800 per week participating in a contracted in DC pension scheme pays employee contributions equal to 5% of earnings, i.e. £40 per week. NICs are paid on salary before pension contributions are deducted, therefore the individual would pay NICs as follows:
(£800 – £166) x 12% = £76.08

The employer would pay NICs as follows:
(£800 – £166) x 13.8% = £87.49

Under a salary sacrifice arrangement, assuming all the above £40 per week is paid directly by the employer to the DC pension scheme, the individual would earn £760 per week, rather than £800 per week. This would reduce the NICs payable by the individual as follows:
(£760 – £166) x 12% = £71.28, thereby saving £4.80 a week

The employer would pay NICs as follows:
(£760 – £166) x 13.8% = £81.97, thereby saving the employer £5.52 a week (part of which saving could be passed to the employee)

There are disadvantages with salary sacrifice. Advisers should be aware that the use of salary sacrifice arrangements may not be appropriate for low earners if it means that their earnings fall below the Lower Earnings Limit, set at £118 per week in the 2019/20 tax year, because this could have an impact on the individual's access to State benefits (see Chapter 2, Introduction).

Further, all earners could be adversely affected in other ways by the permanent reduction in their earnings given that salary can be used to calculate other benefits provided by the employer (e.g. death benefits and sickness benefits). While the employer could allow for such knock-on effect in any introduction of a salary sacrifice arrangement, salary is also used in calculating redundancy pay (again employer related benefit) and determining eligibility for a private loan, especially mortgages. Careful consideration of all aspects is essential in the advice process.

Care is also needed with respect to persons who earn in excess of £150,000, at which point the taper starts to apply to the Annual Allowance (AA), where they enter into an arrangement on or after 9 July 2015: see section 7.4 in Part 1 of this manual for further detail on the operation of taper. An arrangement will include a salary sacrifice arrangement under which the individual gives up the right to income in return for the making of a relevant pension contribution and where this takes his income below the £110,000 threshold triggering the potential calculation of a tapered reduction in the AA. In such circumstances, the salary sacrifice will need to be ignored for the purposes of calculating the trigger.

153 Tax Treatment of Benefits in Kind

Where an employee receives a benefit, such as medical insurance or critical illness cover, they will still be taxed on the value of that benefit.

Not all benefits are subject to tax as a benefit in kind. Additional holiday entitlement (though not payments in lieu of holiday which is not taken) is an example. More significantly in employee benefit planning are contributions paid by an employer to registered pension schemes and life assurance arrangements and contributions to approved profit related pay schemes. Employer contributions to sickness arrangements (provided most staff and not just shareholding directors are eligible) can also be made without the employee suffering a tax charge.

HMRC in deciding whether or not there is a taxable benefit in kind look at whether or not money's worth has been provided and if so that will be regarded as earnings. Under Section 62(3) of ITEPA 2003, money's worth is defined as:

- something that is of direct monetary value to the employee, or
- something that is capable of being converted into money or something of direct monetary value to the employee.

Types of taxable benefits include [see HMRC Tax Guide on Expenses and Benefits 480, Chapter 4.3 and Chapter 1.16]:

- the provision of living or other accommodation, including light, heat, council tax and domestic or other services (unless essential to do job e.g. caretaker)
- the use of any asset provided by the employer or another person acting on the employer's behalf, for example the use of a motorcycle, equipment, furniture or a TV set
- fuel for private motoring in a company provided car
- gifts of assets to the employee, or the sale to the employee of assets at less than their market value (this applies not only to assets such as a car or a house, but also to goods such as clothes, TV sets, wine or groceries)
- any non-exempt expenses or liabilities incurred by the employee and paid direct by the employer, for example, hotel or restaurant bills (unless incurred as part of employee's job), whether paid direct or through a credit card company
- Income Tax not deducted from remuneration paid to a director, but paid to HMRC by the employer and not reimbursed by the director
- scholarships awarded to students by reason of their parents' employment
- any other benefits or facilities of any kind arranged by the employer, for example; hotel accommodation and restaurant facilities, holidays, childcare (some forms of childcare are exempt), sporting facilities (some sporting facilities are exempt), and work carried out at the employee's residence.
- any benefit provided for employees (or members of their families or households) by reason of their employment by someone other than their employer is taxable in the same way as if it had been provided by their employer.

Types of expenses payments and benefits not normally taxable include [see HMRC Helpsheet 207, published 4 July 2014, updated 6 April 2017]:

- Accommodation, supplies and services on your employer's business premises
- Supplies and services provided to you other than on your employer's premises
- Free or subsidised meals
- Meal vouchers
- Expenses of providing a pension
- Medical treatment abroad (if required while abroad on employer's business)
- Medical treatment to help you return to work
- Health screening and medical check-ups (no more than once a year)

- Nurseries and playschemes
- Childcare vouchers
- Other employer-supported childcare
- Certain living accommodation
- Payments by your employer towards additional household costs where you work at home (the employer may pay up to £4 per week without supporting evidence – or a higher amount agreed with HMRC with supporting evidence)
- Incidental overnight expenses
- Travelling expenses
- Travelling and subsistence expenses following strike disruption
- Disabled people's cost of travel between home and work
- Certain retraining costs
- Employer-funded or employer-reimbursed training
- Long service awards
- Suggestion schemes
- Encouragement awards
- Financial benefit awards (arising from suggestions improving efficiency)
- Goodwill entertainment
- Car, motorcycle and bicycle parking
- Certain gifts (not exceeding £250 in value)
- Work to home travel provided when you work late or when sharing arrangements are disrupted
- Work buses and subsidies to public buses
- Christmas or other annual party
- Sports facilities
- Counselling
- Welfare counselling
- Mobile phones (one per employee)
- Bicycles and cycling safety equipment
- Loans for a purpose that attracts tax relief in full
- Cost of advice re employee shareholder agreements.

The Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) contains most of the provisions related to benefits in kind. In ITEPA 2003 Income Tax is chargeable (as mentioned earlier) on employment income that includes:

- earnings – salary, wages, fees and other emoluments
- amounts treated as earnings – including benefits
- amounts which are not earnings but count as employment income.

The employee is entitled to a deduction for any other expenses which are incurred **wholly, exclusively and necessarily** in the performance of the duties of their employment. This includes the cost of journeys in the performance of the duties of the employment (e.g. client visits), or to a different workplace to carry out the duties of the employment, **but not** where the journey is ordinary commuting or private travel to usual place of work.

154 Counselling Services for Employees

There is an exception to taxation on certain benefits in circumstances where counselling or treatment relates directly to an event that has occurred in the process of carrying out the duties of the employment. In practice, however, where counselling services are available to employees generally, the assessable benefit per employee can be very small and tax may not be charged.

No Income Tax charge arises on reasonable outplacement (see below) counselling services provided by an employer for employees whose contracts of employment have been terminated.The exemption applies not only to payments that the employer makes for the counselling itself but also to payments of any other associated fees and travelling expenses necessarily incurred in connection with the provision of the counselling.

Under section 210 ITEPA 2003 and SI 2000 No 2080, welfare counselling provided to an employer's employees generally is exempt from tax on employment income. Welfare counselling means counselling of any kind apart from:

- medical treatment of any kind
- advice on finance, other than advice on debt problems (though workplace advice up to a value of £500 p.a. may be provided tax-free – note that this is a separate initiative to the Pensions Advice Allowance)
- advice on tax
- advice on leisure or recreation, or
- legal advice.

Outplacement

The other type of counselling that is exempt from tax is that relating to outplacement. Where an employee is made redundant, his employer may pay for the employee to receive professional advice and assistance designed to help in coping with the new situation and to find a new job. Such professional advice is known as outplacement counselling and may consist of anything from a single advisory interview to ongoing assistance or advice for a period of several months.

1.55 Ex-gratia *Payments*

Employers can always make such payments to employees (whether past or present) as the employer sees fit.These *ex-gratia* payments are made where the employer is under no contractual obligation to make the payment, and the payment is made to the employee as an individual rather than in return for services rendered.

Ex-gratia payments are generally liable to Income Tax but the first £30,000 will be exempt if it can be proved that the payment was genuinely "*ex gratia*" and not related to any past services as an employee or as consideration for any future obligation that the employee takes on.

1.56 Payments on Termination of Employment

Lump sums paid on termination of employment to which the employee has no contractual entitlement are subject to special rules on their taxation. The first £30,000 of the payment is tax free but any part of the sum that exceeds £30,000 is taxable in full at the employee's marginal tax rate. Benefits that continue after the date of termination of employment are taxable (once the £30,000 limit has been exceeded) for the tax year in which they are received. These rules apply to non-contractual termination payments and statutory redundancy pay. Although a statutory redundancy payment is tax free it nevertheless counts towards the £30,000 threshold.

Apart from usual pay, an individual might receive other payments when they leave work. Some of these are tax free and no tax should be taken off under PAYE for:

- payments due to injury, disability or death
- certain lump sum payments from private pension schemes
- other payments of up to £30,000 for
  - statutory redundancy pay
  - compensation for loss of employment
  - pay instead of notice (sometimes referred to as "pay in lieu of notice") if there was no entitlement to it under contract or other form of understanding or representation made by the employer that the payment will be made.

1.57 Pension Benefit Implications

In spite of recent tightening of the fiscal rules relating to employee benefits, pension schemes are still tax efficient. Contributions to a registered pension scheme, within the prescribed limits, are not regarded as benefits in kind for tax purposes. Both the employer and the employee get tax relief on contributions made to a registered occupational pension scheme, subject to the new limits introduced in the 2011 Finance Act and subsequently.

The Annual Allowance (AA) has now been reduced (from the comparatively generous 2006/11 levels) to £40,000 and, up to this limit, tax relief will normally be given to individuals at their marginal tax rate.

The AA is considered in detail in Part 1 of this study manual.

1.58 Trust Income

Trustees may receive income from investments such as bank interest, dividend income from stocks and shares or rental income from land or buildings. Different types of trust income may have different rates of tax. The two main types of UK family trusts are Accumulation/discretionary trusts and Interest in Possession trusts.

The tax position for trusts changed on 6 April 2016. For the 2015 to 2016 tax year and earlier tax years, there was a 10% tax credit on dividends from UK companies (and some non-UK companies). The first £1,000 of dividends were not taxed as the tax credit covered them but dividends over £1,000 were taxed at 30.56%

Accumulation/discretionary trusts

Trustees are responsible for paying tax on income received by accumulation or discretionary trusts. From 6 April 2016, the first £1,000 is taxed at the standard rate.

If the settlor has more than one trust, this £1,000 is divided by the number of trusts they have. However, if the settlor has set up 5 or more trusts, the standard rate band for each trust is £200.

The tax rates are:

Trust income up to £1,000

Type of income	**Tax rate**
Dividend-type income (from shares)	7.5%
All other income (from savings, business income rent etc.	20%

Trust income over £1,000

Type of income	**Tax rate**
Dividend-type income (from shares)	38.1%
All other income (from savings, business income rent etc.	45%

Trustees do not qualify for the new Dividend Allowance, introduced for individuals from 6 April 2016. This means trustees pay tax on all dividends depending on the tax band they fall within.

Interest in Possession trusts

This is a trust where the beneficiaries have a right to the income of the trust, after expenses, as it is produced. These are sometimes known as non-discretionary trusts. For interest in possession trusts, the trustees are responsible for paying Income Tax at the rates below:

Type of income	Income Tax rate
Dividend-type income (from shares)	7.5%
All other income (from savings, business income rent etc.	20%

Sometimes the trustees 'mandate' income to the beneficiary. This means it goes to them directly instead of being passed through the trustees. If this happens, the beneficiary needs to include this on their Self Assessment tax return and pay tax on it.

Settlor-interested trusts

These are where the settlor or their spouse or civil partner benefits from the trust. The trust could be:

- an interest in possession trust
- an accumulation or discretionary trust.

The settlor is responsible for Income Tax on these trusts, even if some of the income is not paid out to them. However, the Income Tax is paid by the trustees as they receive the income.

1. The trustees pay Income Tax on the trust income by filling out a Trust and Estate Tax Return.
2. They give the settlor a statement of all the income and the rates of tax charged on it.
3. The settlor tells HMRC about the tax the trustees have paid on their behalf on a Self-Assessment tax return.

Bare trusts

Assets in a bare trust are held in the name of a trustee. However, the beneficiary has the right to all of the capital and income of the trust at any time if they are 18 or over (in England and Wales), or 16 or over (in Scotland). This means the assets set aside by the settlor will always go directly to the intended beneficiary.

Bare trusts are often used to pass assets to young people – the trustees look after them until the beneficiary is old enough.

The beneficiary of a bare trust is responsible, or trustee on behalf of a minor if income is paid, for paying tax on income from it.

159 Other Allowances, Reliefs and Expenses for the Self-Employed

Where an individual is self-employed there are various deductions, relief and allowances that can reduce his tax bill. Unlike the position for employees where deductions for expenses need to "wholly, exclusively and necessarily" for the purposes of employment, for the self-employed deductions for expenses need to satisfy only a "wholly and exclusively" test. Much of the business expenditure can be deducted from an individual's profits and special reliefs can be claimed for certain capital expenditure. Usually expenditure will fall into one of three categories – capital, business and private – and the type of expenditure will determine whether the individual will get tax relief for it.

Capital Expenditure

HMRC defines this as buying, creating or improving a business asset that an individual keeps to earn the profits of the business. This would include the cost of buying business premises, machinery, vans, computers, fixtures and furniture. While capital expenditure does not benefit from Income Tax reliefs, it may be possible to claim capital allowances against profits.

Business Expenditure

Tax relief is available for business expenditure provided it is not capital expenditure or specifically non-allowable (e.g. entertaining expenditure). To be allowable expenditure it must be "wholly and exclusively" for carrying on and earning the profits of the business. An individual can get some private benefit from the expenditure and still get tax relief for the amount spent on the business, provided either:

- the private benefit was incidental and not the reason for the expenditure
- the expenditure can be clearly identified and separated between business and private purposes.

The most common expenses that are normally allowable include: the cost of stock, payroll costs, premises costs, repairs, motor and travel expenses, finance costs, administration costs and professional fees. The full amount of the allowable business expenditure can be deducted from the individual's business income to work out the taxable profits.

In addition to this, an allowable expense would include the interest paid on a bank or other business loan, including alternative finance payments. The repayment of loans, overdrafts or other financial arrangements is non-allowable expenditure.

Private Expenditure

Private expenditure is what an individual spends on his day-to-day living expenses and normal household expenses, including the amount taken from the business as a wage. Private expenditure is non-allowable expenditure.

15.10 Self-Assessment and Payment of Tax

Many taxpayers with simple affairs who pay their Income Tax through PAYE do not need to make an annual tax return.

Where a tax return is required, many others, including the self-employed, file their tax return electronically through the HM Revenue & Customs' internet service on the website at **www.hmrc.gov.uk** Where HMRC requires a return it will send a notice after the end of the tax year, requiring the individual to file a return. HMRC does not automatically issue paper returns but will provide one on request. Its policy is to encourage filing of returns online: this is reflected by the different filing deadlines for paper, 31 October, and electronic returns, the following 31 January.

Taxpayers who do not receive a notice to file, but have received untaxed income or made a capital gain in the tax year have to inform HM Revenue & Customs by 5 October following the end of the tax year. However, for National Insurance purposes a taxpayer who starts a new self-employment must notify the HM Revenue & Customs within three months of starting up in self-employment.

HMRC collects tax due through its Accounts Offices in Shipley and Cumbernauld. Collection of tax is made using three main methods.

Pay As You Earn (PAYE)

Income from employment for employees is assessed on a current year basis. Tax is usually paid during the year under the PAYE system, by deduction through the payroll. Adjustments to an individual's tax code can be used to collect tax owed or to refund any overpayments (though in the latter case the taxpayer is more likely to ask for a cheque refund). More information on tax codes is available at **www.hmrc.gov.uk/incometax/codes-basics.htm**

For the purposes of PAYE, pay is treated as the gross figure before any deductions are taken off. PAYE is deducted from gross pay by the employer (or in the case of a pensioner, the trustees of the pension scheme) and when the individual's tax code is used this effectively and correctly gives tax relief at the employee's marginal rate of tax.

Exceptions to these arrangements apply to an employee's pension contributions and donations to charity under the Payroll Giving scheme.

- Any employee's contributions to a registered pension scheme may be deducted from gross pay before tax is calculated. Both ordinary employee contributions to the scheme and additional voluntary contributions are included in this arrangement, which is known as the net pay arrangement.
- Payroll Giving schemes are approved by HMRC to allow tax relief on gifts to charities.

The employee authorises deductions from their gross pay but such deductions are not free of NIC liability. NICs will still be due on the full gross pay.

Direct Assessment

Under the Tax Law Rewrite project, the legislation on annual payments and deduction of tax has been simplified, and the concept of 'charges' has been replaced by an ordinary deduction from income. Under ITA07, Direct Assessment is likely to be required in few cases. Where it does apply, an assessment can be made by an HMRC officer, irrespective of where the income arises and where the taxpayer resides (see Regina v General Commissioners of Income Tax for Tavistock (ex parte Adams) (No 2) (1971)). The location of the source of income and/or the residence of the taxpayer is only of importance in relation to jurisdiction to hear appeals. For administrative convenience, however, assessments should normally be made in the Taxpayer Service Office. Self-Assessment Income Manuals, SAIM 9040 and 9170 contain further information, though the student will not be required to know the detail of these for examination purposes.

Self-Assessment

Under the self-assessment regulations payment of Income Tax which has not been collected under PAYE or by deduction at source can be assessed. Such income may consist of rental income and can, for higher and additional rate taxpayers, also include income from which basic rate tax has already been deducted. (It is important for the adviser to be aware of all his client's income sources since this could impinge on planning.)

An individual who fills in a self-assessment tax return makes a final assessment of the amount of tax which must be paid. Any balance of tax due must be paid by the 31 January following the end of the relevant tax year. Penalties become due if the tax return is not sent in to the tax office by the 31 January.

- The deadline for submitting a paper tax return is generally 31 October following the year end (there are exceptions for certain taxpayers for whom e-filing is impossible or inappropriate).
- Anyone who wants HMRC to include a tax underpayment in their PAYE code needs to submit their online return before 31 December following the tax year end.
- The general deadline for online returns is 31 January following the end of the tax year. Penalties for missing the tax return deadline range from £100 where return is one day late to £1,000 if three months late. Thereafter, further penalties can apply of at least £600 in aggregate plus 5% of tax due.

The deadlines are different for partnerships which have corporate members:

- where the partnership's accounting date falls between 6 April and 31 January the filing deadlines are the same as for individuals, i.e. the following 31 October for paper returns and the following 31 January for electronic returns;
- where the accounting date falls between 1 February and 5 April the deadline for paper returns is 9 months after that accounting date and for electronic returns 12 months after that accounting date. Any members of the partnership who are individuals are required to file their own personal tax returns before the partnership return is required.

An individual must pay tax directly to HMRC on the normal due dates. The balance of any tax owed must be paid by 31 January following the end of the tax year. This is also the date on which an individual may have to pay one of two "payments on account" towards his next tax bill. The second "payment on account" towards the next tax bill is paid on the following 31 July. If the individual does not pay the tax owed for the previous tax year on time he will be liable to penalties and interest on the amount owed. This does not apply to any payments on account that are paid late.The penalties for late payment start at 5% of tax due if 30 days late and range up to 15% if 12 months late.

The individual will also pay interest on anything owed which has not been paid, including any unpaid penalties, until HMRC receives the payments.

It is possible to appeal against penalties if there is a reasonable excuse for late payment or filing.

15.11 Tax Planning

Individuals may be able to reduce their tax liability in a number of ways.These include:

- paying contributions into a registered pension arrangement
- using their Individual Savings Account (ISA) allowances fully to ensure that income from savings builds up tax free
- using the Personal Savings Allowance for all but additional rate taxpayers
- using for lower earners the Starting Rate Limit for Savings
- using Capital Gains Tax exemption or reliefs that apply and use EISs if appropriate for deferring CGT
- ensure that where possible assets are transferred to married partners
- consider deferring taxation through use of insurance company Bonds
- making use of allowances for children and products such as Junior ISAs.

Advisers should ensure that clients are taking full advantage of these exemptions, reliefs and all other Allowances to reduce their Income Tax liability when making recommendations on investment planning. Specific points summarised above are covered in more detail elsewhere in the DRRA study materials.

In dealing with a client's tax affairs the adviser should treat all data as confidential. Data protection principles (covered elsewhere in the DRRA study materials) apply fully to tax matters as well other personal and financial data.

Example

To illustrate how a person can draw tax efficient income in fiscal 2019/20 follows. Assume an income from pensions of £12,500, dividends of £2,000 and interest from building society accounts amounting to £7,500 of which £1,500 comes from ISAs.

ISA income is exempt and is therefore ignored. No tax would be payable on the aggregate residual income of £20,500 because it is matched by allowances as follows:

- Personal allowance £12,500
- Starting Rate income tax band for Savings £5,000
- Personal savings allowance £1,000
- Dividend allowance £2,000

In addition if relevant to his circumstances the client could obtain

- Capital Gains Tax annual exempt amount of up to £12,000
- 5% withdrawals from insurance company bonds (plus any unused 5% from earlier years)
- ISA withdrawals (income as in above Example as well as capital).
- EIS and VCT reliefs (though for clients with lower levels of income these investments may not be appropriate)
- (while unlikely in this retirement scenario) pay pension contributions to reduce taxable income

1.5.12 Gift Aid

Gift Aid increases the value of donations to charities and Community Amateur Sports Clubs by allowing them to reclaim basic tax relief on an individual's gift. Where the individual is a higher or additional rate taxpayer, he can claim extra relief on donations. This is the difference between the rate of tax paid at 40% or 45% and the basic rate of tax paid at 20% on the total "gross" value of the donation paid.

Example

An individual donates £100, Gift Aid adds an additional £25 to this (i.e. the gross value).The individual can claim back:

- £25 if tax is paid at 40% (i.e. £125 x 20%)
- £31.25 if tax is paid at 45% (i.e. £125 x 25%).

The taxpayer needs to inform HMRC of his Gift Aid donations each year. This can be done on an individual's self-assessment tax return or, where the individual does not complete a return, on form P810 Tax Review which is available from the individual's tax office.

In addition to higher rate taxpayers (especially those who start to lose the Personal Allowance when gross earnings exceed £100,000), individuals who claim the Married Couple's Allowance or tax credits should inform HMRC about any Gift Aid donations. HMRC will subtract the "grossed" up donation from the individual's total income and use the reduced figure to work out the value of the individual's allowances or tax credits.This may increase these allowances or credits if the individual's income was above the relevant "income limit" that applies (see above).

Basic rate tax-payers do not need to take any further action with HMRC. However, should their income drop below the Personal Allowance level during a tax -year, perhaps temporarily as part of a tax-planning exercise for drawdown clients, then because the charities will have reclaimed the tax on the grossed up amount, a tax bill could be presented to the client for the tax no longer due.

1.6 NON-UK RESIDENTS

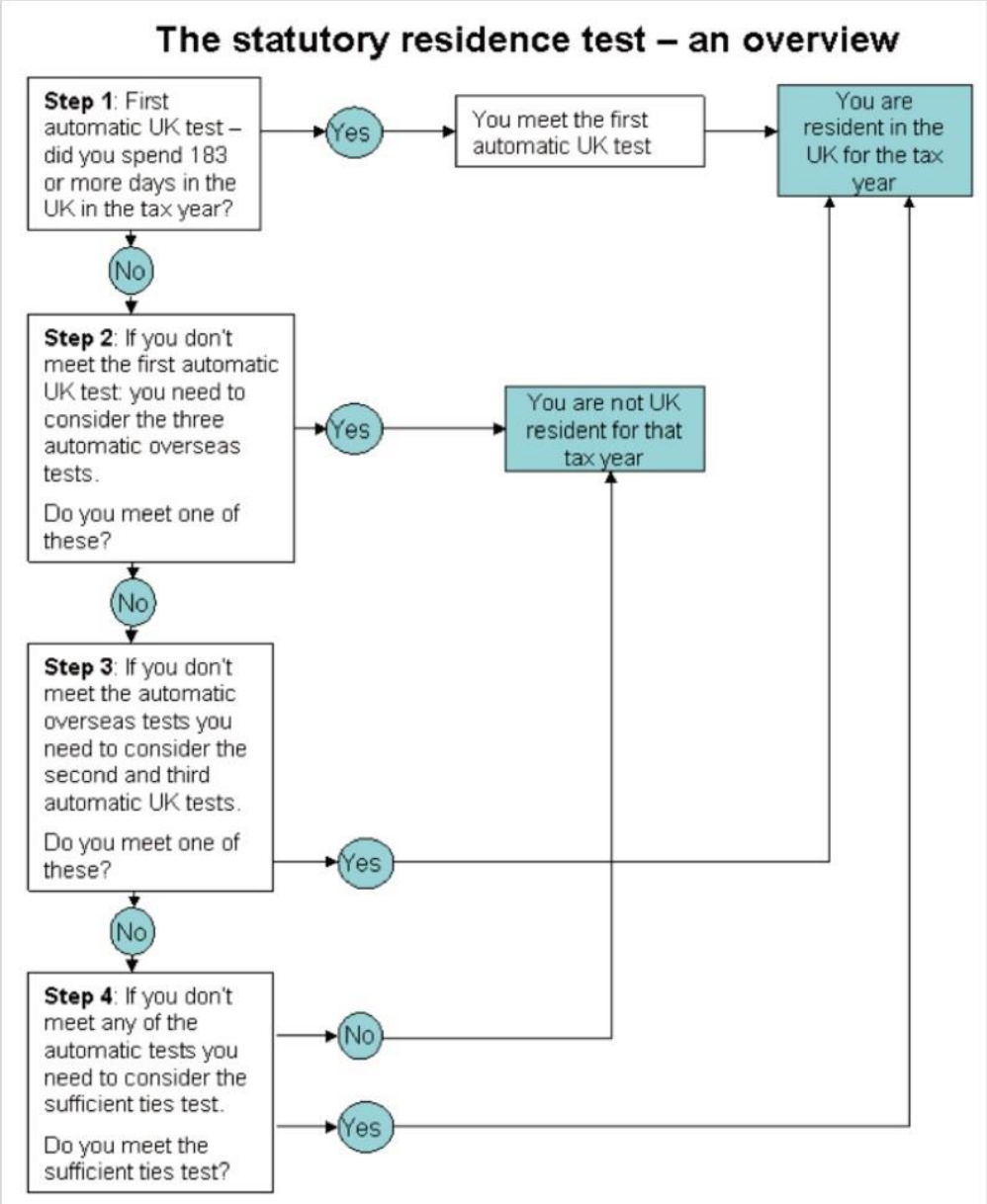
Guidance Notes were produced by HMRC in 2013, updated in June 2016, to detail how residence and domicile affect an individual's tax liability. Guidance Note RDR1 (RDR1) published in October 2013 gives information about how residence status and domicile status affect the payment of tax in the UK on foreign income or foreign chargeable gains from the 6 April 2013 onwards. (Note that "RDR" in this context is the mnemonic for Residence, Domicile and Remittance not the perhaps more familiar Retail Distribution Review.) It refers to the statutory residence test (SRT), which was introduced in Finance Bill 2013. RDR1 also gives information on the remittance basis of taxation from 6 April 2013.

1.6.1 Statutory Residence

As mentioned in section 1.2 above, the basic rule governing the statutory residence test is that anyone who is present in the UK on 183 days or more in the tax year is UK-resident. Every day is counted on which the individual was present in the UK and remained so past midnight. There is one exception to the day counting rule in the context of the 183 days test:

- transient passengers who stay past midnight when passing through the UK and undertake no activities here that are not related to their journey do not count those days but any digression for another purpose, business, social or family, will mean that the day has to be counted.

The details of the Statutory Residence Test are set out in Guidance Note RDR3 ("RDR3") first published in December 2013 (updated August 2016) following the primary legislation introduced by Schedule 45 to the 2013 Finance Act.This publication provides the following flowchart:



1.6.2 Automatic Overseas Tests

If an individual meets any of the following automatic overseas tests for a tax year, that individual is automatically non-resident for that year:

- First automatic overseas test: resident in the UK for one or more of the three tax years preceding the tax year, spending fewer than 16 days in the UK in the tax year. If an individual dies during the tax year this test does not apply.
- Second automatic overseas test: resident in the UK for none of the three tax years preceding the tax year, spending fewer than 46 days in the UK in the tax year.
- Third automatic overseas test: working full-time overseas over the tax year, without any significant breaks during the tax year from overseas work. For the third automatic test to apply the individual needs to spend fewer than 91 days in the UK in the tax year and the number of days in the tax year on which the individual works for more than three hours in the UK is less than 31. The third automatic overseas test does not apply if the individual has a relevant job on board a vehicle, aircraft or ship at any time in the relevant tax year, when at least six of the trips made in that year as part of that job are cross-border trips that: begin in the UK, end in the UK, or begin and end in the UK.

If the individual does not meet any of the automatic overseas tests, he is resident in the UK if he meets any of the following UK tests:

- First automatic UK test: spending 183 days or more in the UK in the tax year.
- Second automatic UK test: having (or had) a home in the UK during all or part of the tax year. This test will be met if there is at least one period of 91 consecutive days, at least 30 days of which fall in the tax year, when the individual has/had a home in the UK in which a sufficient amount of time (at least 30 days) was spent, and either the individual has no overseas home, or has an overseas home or homes in each of which you spend no more than a permitted amount of time (fewer than 30 days). (If the individual has more than one home in the UK, each should be considered separately to see if the test was met. The test only needs to be met in relation to one of the UK homes.) The sufficient and permitted amounts of time tests operate in respect of the full tax year. The days when the individual is present in the home do not need to fall within the 91-day period, but they must fall within the tax year.
- Third automatic residence test: working full-time in the UK for 365 days or more with no significant break from UK work and all or part of that work period falls within the tax year, and more than 75% of the total number of days in the tax year when the individual does more than three hours work are days when the individual does more than three hours work in the UK, and at least one day which is both in the 365-day period and in the tax year is a day on which the individual does more than three hours of work in the UK.

If an individual meets any of the automatic UK tests, that individual is resident in the UK for the tax year.

If the individual does not meet any of the automatic overseas tests or any of the automatic UK tests, the "sufficient ties" test is used to determine UK residence status for a tax year. Connections to the UK are called ties and taken together with the number of days spent in the UK, are used to determine whether they are sufficient for the individual to be considered UK resident for tax purposes for a particular tax year. If the individual was not UK resident for any of the three tax years before the tax year under consideration, the ties to be consider are a family tie, an accommodation tie, a work tie and a 90-day tie. If the individual was resident in the UK for one or more of the three tax years before the tax year under consideration, a country tie (where, briefly, the country where you spend most of your time is the UK) also needs to be considered. All these ties are described in more detail in RDR3.

The complexities of RDR3 bear witness to past case law battles. Primary legislation and Regulations, supplemented with Guidance Notes, establish the taxation principles but case law inevitably evolves to help

resolve disagreements arising in the way the principles are interpreted in practice. Any adviser involved with a client who might or might not be regarded as UK/overseas resident should look carefully at the detail of HMRC guidance and, probably, ensure that a specialist adviser is also involved.

Previous HMRC guidance was provided in booklet HMRC6 (which replaced the former booklet IR20 on 25 March 2009) and this remains relevant for taxation liabilities up and including 5 April 2013.

1.6.3 Ordinary Residence

Up to 5 April 2013, an individual's tax position could be affected if they were ordinarily resident in the UK. However, from 6 April 2013, the concept of ordinary residence has largely been abolished for tax purposes.

If resident in the UK year after year, an individual was treated as ordinarily resident here. They could be resident but not "ordinarily" resident in the UK for a tax year if, for example, they normally lived outside the UK but were in this country for 183 days or more in the year. Or they could have been ordinarily resident but not resident for a tax year if, for example, they usually lived in the UK but had gone abroad for a long holiday and did not set foot in the UK during that year.

1.6.4 Domicile

For Income Tax and Capital Gains Tax purposes, whether or not an individual is domiciled in the UK may affect what UK tax is paid on any foreign income and gains during a tax year. If a person does not have foreign income and gains then domicile status has no bearing on UK Income Tax or Capital Gains Tax.

Domicile status may also be relevant for Inheritance Tax.

Domicile is not the same as residence (or nationality). It is established under case law precedents. Domicile is where you make your home, where you intend to return and, ultimately, where you intend to be buried.

You must normally not be without a domicile, and you only have one domicile at a time. There are three types:

- Domicile of origin. Everyone acquires a domicile of origin at birth. This is usually the country which an individual's father considered to be his permanent home at the date of the individual's birth. If the parents were unmarried when the individual was born, domicile of origin comes from the mother. Domicile of origin continues until a new domicile is acquired. So for someone born outside the UK, then their non- UK domicile of origin is likely to still apply unless the individual intends to remain in the UK permanently or indefinitely.
- Domicile of dependence. An individual legally dependent on another person, e.g. a natural or adopted child or a person lacking mental capacity, will automatically have the same domicile as the other person, even if the non-dependant's domicile changes. Note: a woman married before 1974 automatically acquired and retained the same domicile as her husband.
- Domicile of choice. After the age of 16, domicile can be changed e.g. live in a country other than your previous country of domicile and intend to remain there. This creates a 'domicile of choice'. HMRC may well require objective evidence.

If an individual completes a Self-Assessment tax return he/she may be required to declare whether or not they are domiciled in the UK. HMRC might not agree with that declaration and will expect an explanation as to how it was reached. If an individual has no foreign income or foreign gains there is no need to tell HMRC about domicile as it will not be relevant to the Income Tax and Capital Gains Tax payable.

'Deemed domicile' is a concept that applies only to Inheritance Tax. Even if a person is not domiciled in the UK under general law, they may still be deemed domiciled in the UK and therefore liable to pay Inheritance Tax. More about deemed domicile is included in HMRC's Inheritance Tax Customer Guide.

It is possible to live or work temporarily in one country, but be domiciled in another. For example, an individual may be resident in the UK but regarded as domiciled abroad if he/she:

- spends most of the time in the UK;
- was born abroad and their father (or mother, if parents were not married) was not UK domiciled when they were born;
- has strong links to the country in which their father was domiciled;
- does not intend to remain in the UK permanently or indefinitely.

Domicile status may affect what Income Tax and Capital Gains Tax is paid in the UK if both of the following apply:

- UK resident and not domiciled in the UK;
- foreign income or foreign capital gains apply.

If the above do apply, tax will be levied normally on UK income and UK capital gains, but there is a choice as to how tax applies to foreign income and capital gains. Either the 'arising basis' or the 'remittance basis' can apply. The arising basis applies to all income and gains wherever in the World they arise. The remittance basis applies only to any income and gains (including property derived therefrom) brought (i.e. remitted) to the UK.

Non-UK domiciliaries who are resident in the UK are taxed in the same way as resident UK domiciliaries unless they claim to be assessed on the remittance basis. A claim to remittance basis may be made for any year (but no claim is necessary if the taxpayer is aged under 18 throughout the year or has unremitted income and gains totalling less than £2,000). If the remittance basis is claimed income and gains that arise overseas are not taxed as they arise: instead they are taxed when they are brought into the UK (i.e. "remitted"). Where an individual chooses to use the remittance basis of taxation he will need to make a claim to use it for each year they wish to do so on their self-assessment tax return. They will also need to indicate whether they meet any of the three residence tests for the relevant tax year (see "Remittance Basis Charge" below).

Remittance is any money or other asset (e.g. property or investments) which is derived from foreign income and/or foreign gains that have not been taxed in the UK and is brought into the UK by or for the benefit of a "relevant person" (i.e. the taxpayer, his spouse, civil partner, child or grandchild). This can also include companies and trustees of settlements connected to a relevant person. A remittance also includes using foreign income and/or gains to pay for a service provided in the UK.

In certain circumstances remittances of foreign income or gains can be treated as if they were not remitted to the UK and are, therefore, not liable to UK tax. These are commonly referred to as exemptions and include:

- items of clothing, footwear, jewellery or watches brought to the UK for personal use
- works of art and similar items brought to the UK for display or repair, or where they are only in the UK temporarily
- items with a value of less than £1,000
- payment of the remittance basis charge (see below)
- certain qualifying investments (such as those invested in qualifying businesses in the UK)
- certain sales of exempt property in the UK originally purchased with foreign income or gains.

Special rules apply to catch and tax indirect remittances such as via gifts to connected persons and receipt of goods or services in the UK that are paid for out of offshore funds.

Management of the remittance basis by non-domiciliaries is potentially highly complex and requires specialist tax advice.

1.6.5 Remittance Basis Charge

Non-domiciliaries who spend a significant amount of time in the UK may elect to use the remittance basis so that UK tax is only paid on foreign income and gains when they are brought to this country. But such non-domiciliaries may only choose the remittance basis if they pay an annual tax charge of £30,000, £60,000 or £90,000. Since 2008, making the election has meant forfeiting a claim to both the Personal Allowance and the Annual Exempt Allowance for Capital Gains Tax.

For these wealthy non-domiciliaries who choose to spend most of their time in the UK, the Remittance Basis Charge is a tax on unremitted overseas income. Those who are over the age of 18 are liable to the charge in any particular tax year if they claim the remittance basis and have been resident in the UK for at least 7 of the 9 years immediately preceding the year of claim. As from the tax year 2012/13 onwards, for those who have been resident in the UK for 12 of the 14 years immediately before the year of claim the charge is £60,000 (increased from £50,000 on 6 April 2015). In other cases it is £30,000. A further category was introduced from 6 April 2015 (and later modified): non-domiciliaries who have been resident in the UK for 15 of the last 20 years: here the annual charge is £90,000.

Where the annual charge is paid, it is treated as tax on unremitted amounts. Individuals can choose the unremitted income or gains on which the £30,000, £60,000 or £90,000 is paid. Those sums will then not be taxed when they are eventually remitted to the UK.

If the RBC is paid using untaxed foreign income and/or gains from outside the UK the payment might be regarded as remittance and charged to UK tax. To avoid this it should be paid direct to HMRC by a cheque drawn on a foreign bank account or by an electronic transfer of funds.

Other non-domiciliaries who are entitled to the remittance basis without paying the annual charge however long they have been in the UK are as below:

- Those under 18.
- Those with unremitted income and gains for the tax year in question of less than £2,000.
- Those with no UK income or gains other than taxed income up to £100 for the tax year in question and who make no remittances to the UK.

1.7 WORKING ABROAD

An individual who leaves the UK to work full-time abroad under a contract of employment, is treated as not resident from the day after the date of departure, subject to meeting all the following conditions:

- the absence from the UK and the employment abroad both last for at least a whole tax year;
- during the absence any visits made to the UK;
  - total less than 183 days in any tax year, and
  - average less than 91 days a tax year. (The average is taken over the period of absence up to a maximum of four years. Any days spent in the UK because of exceptional circumstances beyond the individual's control, e.g. illness of the individual or a member of their immediate family, are not normally counted for this purpose).

This Working Abroad exemption does not normally apply to Crown/public employees. Their earnings are still regarded as subject to UK tax.

Summary

Income is classified depending on its source. ITEPA covers employees and ITTOIA mainly covers the self-employed. ITA covers all people liable for Income Tax and includes taxable income not dealt with elsewhere in the legislation. Examples include Bank and Building Society interest where tax is deducted at source.

Self Test Questions

- Under what legislation would a self-employed person be assessed for Income Tax purposes?
- What are the component parts of total income for tax purposes?
- In relation to benefits in kind what is the significance of earning more than £8,500 p.a.?
- When might a person's domicile be significant for tax purposes?

INTRODUCTION

Where an individual is paying Income Tax they will probably also be paying National Insurance Contributions (NICs). NICs build up an individual's entitlement to certain State benefits, including the State Pension. The NICs paid depend on how much the individual earns and on whether he is employed or self-employed; there is also an option to pay voluntary NICs. The Office for Budget Responsibility estimated 2017/18 NICs at £130.3 billion: 17.5%t of all receipts, equivalent to £4,600 per household and 6.4% of national income.

An employee or self-employed person pays NICs once he is aged 16 or over and has earnings of more than a certain level. An employee stops paying Class 1 NICs when he reaches State Pension Age (but his employer's Class 1 NICs would still be payable). If self-employed, an individual stops paying the flat-rate Class 2 contributions as soon as he reaches State Pension Age and Class 4 contributions, which are profit-related, from the start of the tax year after the one in which he reaches State Pension Age.

Some people also pay voluntary NICs. They might choose to do this where they are not working and are not claiming State benefits, where they have not paid enough NICs in a year for it to count for the State pension or other long term State benefits or where they are living abroad and want to maintain State benefit entitlement. The benefits which depend on an individual's NIC Class 1 record include (see **https://www.gov.uk/national-insurance/what-national-insurance-is-for**) for data re other Classes of NICs:

- Basic State Pension/Additional State Pension
- New State Pension
- Maternity Allowance
- Contribution-based Jobseeker's Allowance
- Contribution-based Employment and Support Allowance
- Bereavement benefits

2.1 CLASSES OF NATIONAL INSURANCE CONTRIBUTIONS

The amount and Class of NICs paid by an individual depends on whether he is employed or self-employed and on how much he earns.

2.1.1 NICs for Employees

Employees pay Class 1 NICs on their gross salary, which includes earnings and any other benefits in kind, such as a company car. In the 2019/20 tax year, an individual can earn up to £166 a week (the "Primary Threshold") before paying NICs, but he will still build up entitlement to the basic State pension and certain other benefits if he earns more than £118 a week (the "Lower Earnings Limit").

The employee's Primary Class 1 rate is 12% paid on earnings between the Primary Threshold and the Upper Earnings Limit, and 2% on earnings above the Upper Earnings Limit, £962 per week for 2019/20.

It may also be possible to defer payment of some NICs to avoid overpayment. If an employee has more than one job and thinks that they will earn more than the annual equivalent of the Upper Earnings Limit, they can ask HMRC for permission to defer some of their employee's NICs liability. If the employee's application is approved, HMRC will send the employer form CA2700 authorising them to deduct employee's NICs at a rate of 2% on all their earnings above the Primary Threshold. (Employer's NICs remain payable in full at the 13.8% rate since there is no cut-off point at the Upper Earnings Limit.)

Where an individual is a director, his NICs are worked out over an "annual earnings period" running from 6 April to the following 5 April, rather than on a weekly or monthly basis that applies to other employees.This is to ensure that the correct NICs are paid.

Prior to April 2016, employees earning above the Lower Earnings Limit could also build up entitlement to the State Second Pension (S2P) (or earlier iterations of earnings-related State pensions) if they were a defined benefit pension scheme. Before 6 April 2012, it was also possible to contract out of S2P by joining a personal pension scheme or a money purchase occupational pension scheme and receive rebates from the DWP into his pension. Where an employee was a member of a DB pension scheme that was "contracted out" of S2P he paid reduced NICs. Contracting out, however, ceased: from April 2016, and the Basic State Pension and S2P has been replaced by the New State Pension of £168.60 from April 2019, assuming a full contribution record. If an individual was contracted out of the S2P he will lose some or all of his entitlement to S2P, but broadly-speaking, this will be replaced by a pension received from a private pension scheme.

Employers: Employers pay Class 1 NICs on their employees' earnings and Class 1A and 1B on benefits in kind,

2.12 NICs for the Self-employed

The self-employed pay Class 2 and Class 4 NICs. Class 2 NICs are paid at the flat rate of £3.00 per week for the self-employed in respect of earnings from the Small Profits Threshold (£6,365 for 2019/20) to the Lower Profits Limit (£8,632). Class 2 NICs are paid at a flat rate of £3.005 a week in 2019/20 and can be paid either monthly or 6-monthly by direct debit. From April 2011 the 6-monthly payments are due on 31 January and 31 July, the same as a self-assessment tax bill. Class 4 NICs are paid as a percentage of annual profit at the rate of 9% on profits between £8,632 and the Upper Profits Limit of £50,000, and a further 2% on profits above the Upper Profits Limit. Class 4 NICs are paid when the self-employed person pays his Income Tax.

2.13 Voluntary NICs

Individuals can pay Class 3 NICs (voluntary contributions) at a flat rate of £15.00 per week in 2019/20. These are paid either monthly by direct debit or by quarterly bill. If an individual has gaps in his NICs record he can make one-off payments of voluntary contributions to fill these. It may not, however, always be beneficial to pay voluntary contribution. It depends on several things, including how much the individual has already paid and the date on which he reaches State Pension Age.

Prior to April 2015 a self-employed person could hold a "certificate of small earnings exception" meaning that he did not have to pay Class 2 NICs. He could still have paid NICs voluntarily because in this situation it was normally better to pay Class 2 contributions voluntarily than to pay Class 3 – it cost less and gave the individual a wider range of State benefits. After April 2015 self-employed earners whose earnings are less than £6,205 may still choose to pay Class 2 contributions for the same reasons.

The Government also introduced from October 2015 an option to allow persons reaching their State Pension Age before 6 April 2016, when the new single-tier State Pension commenced, to pay a voluntary lump sum amount of Class 3A contributions to augment their State Pension. Up to £25 per week extra State Pension (not quite as generous as the Basic State Pension because the triple lock does not apply) could be purchased with lump sum payments which reduced with age. The option remained available to April 2017. The following link provides further information: **www.gov.uk/state-pension-topup** .

2.14 Other NIC Rates

There are other rates that apply in certain circumstances, such as the married women's reduced rate (and special rates for share fishermen and volunteer development workers).

Until April 1977 married women and widows could elect to pay a reduced rate of Class 1 NICs when employed and not to pay Class 2 NICs when self-employed. Where a woman is an employee and holds a valid "certificate of election", her NIC percentage rate for earnings between the Primary Threshold and the Upper Earnings Limit is reduced from 12% to 5.85%.

A woman loses the right to pay reduced NICs if:

- she gets divorced or the marriage is annulled
- she opts to pay Voluntary NICs
- she has not had any earnings on which Class 1 contributions are payable or has not been self-employed for two consecutive years.

Once the right to pay the married women's rate has been given up, it cannot be reclaimed.

The period when a woman pays the married women's reduced rate NICs does not count towards "contributory benefits" like the State pension and bereavement benefits. However, regardless of whether she paid reduced rate National Insurance Contributions as a married woman, she can still claim benefits based on her husband's (or former husband's or late husband's) contributions from his State Pension Age.

Advisers will need to bear in mind that older female clients may not have a full NI record in their own right and may be relying on a spouse's (or perhaps a former spouse's up to the date of divorce) NIC record.

2.2 NATIONAL INSURANCE CREDITS

National Insurance credits are added to any NICs the individual has already paid for the tax year, but will not be awarded if the individual has already paid enough in the year to qualify for the State benefits they cover. There are two types of National Insurance credits:

- Class 1 credits, which count towards entitlement to the State Pension, bereavement benefits and some other State benefits (see list in Introduction to this Chapter)
- Class 3 credits, which count towards entitlement to the State pension and bereavement benefits only.

There are different circumstances in which a person might be able to get credits and these credits may be Class 1 or Class 3. The tables below [Source: https://www.gov.uk/national-insurance-credits/eligibility] show who is (and is not) eligible:

NB These tables are not examinable and are provided for information only.

These tables show if you might be eligible for National Insurance credits, e.g. if you are on Working Tax Credit, Universal Credit or Carer's Allowance.

You need to wait until the tax year is over before you can apply for credits for that tax year.

Looking for work	
Your situation	**How to get credits**
You are on Jobseeker's Allowance and not in education or working 16 hours or more a week	You get Class 1 credits automatically
You are unemployed and looking for work, but not on Jobseeker's Allowance	Contact your local Jobcentre to claim Class 1 credits

Ill, disabled or on sick pay	
Your situation	**How to get credits**
You are on Employment and Support Allowance, or Unemployability Supplement or Allowance	You get Class 1 credits automatically
You are not on Employment and Support Allowance but you satisfy the conditions for it	Contact your local Jobcentre to claim Class 1 credits
You are on Statutory Sick Pay and you do not earn enough to make a qualifying year	Apply for Class 1 credits.Write to: National Insurance contributions and Employers Office,HM Revenue and Customs, BX9 1AN. Include your National Insurance number and say when the credits are for and why you are eligible

On maternity, paternity or adoption pay	
Your situation	**How to get credits**
You are on Maternity Allowance	You get Class 1 credits automatically
You are on Statutory Maternity, Paternity or Adoption Pay, or Additional Statutory Paternity Pay, and you do not earn enough to make a qualifying year	Apply for Class 1 credits.Write to: National Insurance contributions and Employers Office,HM Revenue and Customs, BX9 1AN. Include your National Insurance number and say when the credits are for and why you are eligible

Parents and foster carers	
Your situation on or after 6 April 2010	**How to get credits**
You are a parent registered for Child Benefit for a child under 12 (even if you do not receive it)	You get Class 3 credits automatically
You want to transfer credits from a spouse or partner who got Child Benefit for a child under 16 – before 6 April 2010	Apply to transfer HRP between parents to get Class 3 credits
You are a foster carer, or a kinship carer in Scotland	Apply for Class 3 credits
Your situation before 6 April 2010	**How to get credits**
You are a parent who got Child Benefit for a child under 16 between 6 April 1978 and 5 April 2010, but you did not get Home Responsibilities Protection (HRP) automatically	Claim HRP to get Class 3 credits
You want to transfer credits from a spouse or partner who got Child Benefit for a child under 16	Apply to transfer HRP between parents to get Class 3 credits
You were a foster carer, or a kinship carer in Scotland, between 6 April 2003 and 5 April 2010	Claim HRP to get Class 3 credits

Carers	
Your situation	**How to get credits**
You are on Carer's Allowance	You get Class 1 credits automatically
You are on Income Support and providing regular and substantial care	You get Class 3 credits automatically
You are caring for one or more sick or disabled person for at least 20 hours a week	Apply for Class 3 carer's credits if you are not on Carer's Allowance or Income Support

Family members who care for a child	
Your situation	**How to get credits**
You are a family member over 16 but under State Pension age and you are caring for a child under 12 (usually while the parent or main carer is working)	Apply for Specified Adult Childcare Class 3 credits

On Working Tax Credit	
Your situation	**How to get credits**
You get Working Tax Credit with a disability premium (and you have a small earnings exception if you are self-employed)	You get Class 1 credits automatically
You get Working Tax Credit without a disability premium (and you have a small earnings exception if you are self-employed)	You get Class 3 credits automatically

On Universal Credit	
Your situation	**How to get credits**
You are getting Universal Credit	You get Class 3 credits automatically

Men approaching 65	
Your situation	**How to get credits**
You are between the current women's State Pension age and 65, live in the UK at least 183 days a year and you are in one of these situations: you do not work, you do not earn enough to make a qualifying year, or you are self-employed with a small earnings exception	You get Class 1 credits automatically

On a training course	How to get credits
Your situation	You get Class 1 credits automatically
You are over 18 and Jobcentre Plus sent you on a government-approved training course that lasts no longer than 1 year	
You are over 18 and on a government-approved course that lasts no longer than 1 year but sent by Jobcentre Plus	Apply for Class 1 credits. Write to: National Insurance contributions and Employers Office, HM Revenue and Customs, BX9 1AN. Include your National Insurance number and say when the credits are for and why you are eligible

On jury service	How to get credits
Your situation	Apply for Class 1 credits. Write to: National Insurance contributions and Employers Office, HM Revenue and Customs, BX9 1AN. Include your National Insurance number and say when the credits are for and why you are eligible
You have attended court and you are not self-employed	

Partners of people in armed forces

Your situation	How to get credits
You are married to or a civil partner of a member of the armed forces and went with your partner on an overseas posting after 6 April 2010 and are returning to the UK	Apply for Class 1 credits
You are married to or a civil partner of a member of the armed forces and went with your partner on an overseas posting after 6 April 1975, reach State Pension Age on or after 6 April 2016, and are not getting Class 1 credits	Apply for Class 3 credits

Wrongly imprisoned

Your situation	How to get credits
Your conviction was quashed by the Court of Appeal (or the Court of Criminal Appeal in Scotland)	Apply for Class 1 credits. Write to: National Insurance contributions and Employers Office, HM Revenue and Customs, BX9 1AN. Include your National Insurance number and say when the credits are for and why you are eligible

Who cannot get credits

You cannot usually get credits if you are:

- a married woman paying reduced rate National Insurance
- self-employed and need to pay Class 2 National Insurance

Summary

Where an individual, who has not retired, is paying Income Tax they will very probably also be paying National Insurance Contributions (NICs). NICs build up an individual's entitlement to certain State benefits, including the State pension. The NICs paid depend on how much the individual earns and on whether he is employed or self-employed.

Self Test Questions

- Are employee NICs payable by someone who earns more than the UEL?
- Why might someone choose to pay Class 3 contributions?
- When did married women cease to be able to claim the right to pay reduced NICs?

INTRODUCTION

Capital Gains Tax (CGT) generally applies on disposal of any capital asset (see the definition of a "chargeable gain" in the Definitions section below).The charge arises under the Taxation of Chargeable Gains Act 1992.

Typically a gain arises when an asset is sold for more than its cost (including costs of improvements). It is the gain that is taxed, not the amount received.

Gifts and sales for less than the full value of an asset are also treated as sales for full market value unless the sale was genuinely a bargain at arm's length.

Making a gift to a child, or other people or companies, is a disposal for CGT purposes and the CGT due needs to be calculated. However, making a gift to a spouse, civil partner or charity will not usually lead to CGT (CGT may apply where the taxpayers are separated and not living together or if a transfer of assets to partner's business is involved).

On divorce, separation or dissolution of a civil partnership, assets may be transferred and these are disposals for CGT purposes. Whether liability to CGT arises will depend on the date of transfer and whether the taxpayers are living together at the time.

Also, transferring an asset into another asset, such as a bond, is a chargeable event for CGT purposes.

The owner of an asset may also make a gain if they receive money or money's worth in relation to the asset without selling it. This occurs when, for example the asset is lost or destroyed and the owner receives compensation, or an insurance pay-out.

If an asset which was acquired as a gift is disposed of, the calculation of the gain will normally involve using the market value of the asset at the time it was received.

If an asset is inherited, the estate of the person who died does not pay CGT at that time: potentially Inheritance Tax will have been paid. The CGT liability only arises when the asset is sold or disposed of. At this juncture the gain is worked out by looking at the market value at the time of the death.

Note that some assets are exempt, such as cars, personal possessions disposed of for £6,000 or less and, usually, an individual's main home.

Details of transactions in the tax year which may give rise to a CGT liability must be included in the Tax Return Form (where they exceed certain limits).The liability to pay the appropriate tax arises on 31 January following the end of the tax year.

3.1 RATES OF CAPITAL GAINS TAX

Everyone has an annual tax-free allowance for CGT known as the Annual Exempt Amount (AEA). For the 2019/20 tax year this is set at £12,000 for each individual and one-half of the AEA, £6,000 for most trusts*. If overall gains for the tax year are above the AEA you will pay CGT on the excess.

- An exception to this is a trust set up for a beneficiary who is disabled. In these cases the Annual Exempt Amount is £12,000.

Where gains exceed the AEA, CGT becomes payable. The rate firstly depends on the nature of the asset (this distinction was made from 6 April 2016) and secondly on whether the individual is a basic rate or higher/additional rate tax-payer or trust. If the asset sold is residential property the rates are as follows.

- 18% and 28% tax rates for individuals (28% applying to both higher and additional tax-payers), depending on the amount of taxable income
- 28% for trustees or for personal representatives of someone who has died
- 10% for gains qualifying for Entrepreneur's Relief (explained in section 3.4 below).

While the above rates of 18% and 28% apply for residential property for other chargeable assets they are reduced to 10% and 20% (for trustees as well as higher/additional rate taxpayers). For persons with both types of gain, the relief can be applied first against the gains which would be charged at the highest rates.

Gains arising after 22 June 2010 up to 5 April 2016 depended only on the taxpayer's income. The AEA could be used against the gains charged at the higher 28% rate first to minimise tax owed.

Up to 22 June 2010, CGT was charged at a single rate of 18%. This rate had been in force since 6 April 2008 and applied to individuals and trustees (but not the trustees of a registered pension scheme).

Until 5 April 2008 CGT was payable at Income Tax rates by adding the chargeable gain to an individual's income and applying the relevant top Income Tax rate. From the tax year 1999/2000 to 2007/08 CGT rates were aligned with those for savings income. Gains which (when added to income) were less than the starting rate limit for Income Tax were taxed at 10%. Gains in the basic rate band were taxed at 20%. Where the basic rate limit was exceeded, gains were taxed at 40%.

3.2 DEFINITIONS

3.2.1 Chargeable Gain

A chargeable gain (or allowable loss) arises whenever there is a disposal of an asset by a person which is chargeable unless the transaction is specifically exempt. The term "disposal" includes not only a sale but also a gift, exchange, loss or destruction and, if so claimed, a situation where an asset is reduced to a negligible value. However the following disposals do not give rise to a gain:

- disposals resulting from a death (because Inheritance Tax is potentially payable instead)
- transactions between spouses and civil partners who are living together during the appropriate tax year
- gifts to charities and certain other national bodies (e.g. The National Gallery, The British Museum).

Most assets are chargeable assets including:

- shares in a company
- units in a unit trust
- land and buildings
- higher value jewellery, paintings, antiques and other personal effects (but see the following two sections below)
- assets used in a business
- foreign currency that is not held for personal use or in connection with maintenance of an overseas property.

As a general rule a person who is resident in the UK will be chargeable on assets anywhere in the world. Non-residents are liable in the case of the disposal of business assets in the UK.

Non-UK domiciliaries are assessable on gains from overseas assets as they arise unless they have elected for the remittance basis to apply in the year when the disposal is made. Those gains will be assessable when the proceeds are remitted to the UK.

322 Exempt Assets

Completely exempt:

- private cars
- cash held in sterling
- any foreign currency held for a family's personal use
- chattels such as jewellery, paintings, antiques and other personal effects that are individually worth £6,000 or less (if you have, for example a set of chess figures – you do not pay CGT if the value of the set as a whole is £6,000 or less)
- Savings Certificates, Premium Bonds and British Savings Bonds
- UK Government stocks (Gilts)
- assets held in an Individual Savings Account (ISA) or Personal Equity Plan (PEP)
- betting, lottery or pools winnings
- personal injury compensation.

Partly exempt assets:

- chattels where the sale price is more than £6,000 (the chargeable gain is limited to the lesser of five-thirds of the excess over £6,000 and the actual gain)
- the principal private residence of an individual – whole or partial exemption dependent upon circumstances (see 3.2.3 below).

323 Principal Private Residence Relief

CGT will not apply to the sale or disposal of your own home (for UK residents), if it has been your only home or main residence and it has been used as a home and nothing else.This relief may also apply to the sale of part of the garden without selling the home at the same time.The full amount of relief might not apply if:

- the individual has more than one home (see below)
- part or all of the home has been let out (this does not include having a single lodger)
- the garden or grounds, including the site of the house, is larger than 5,000 square metres
- part of the home has been used exclusively for business purposes, including letting
- the main reason for buying the property was to make a profit from a quick sale.

Private Residence Relief is given automatically. If you do not meet all these criteria then some CGT may be payable.

Any loss on the sale or deposit of your home is not an allowable loss and cannot be set against other gains.

You may need to pay tax when you sell your home if you do not qualify for full Private Residence Relief. If you have tax to pay you need to work out how much gain you made when you sold your home.Your gain is usually the difference between what you paid for your home and what you sold it for. Use the market value instead if:

- it was a gift (there are different rules if it was to your spouse, civil partner or a charity)
- you sold it for less than it was worth to help the buyer
- you inherited the asset (and do not know the Inheritance Tax value)
- you owned it before April 1982

If you are not resident in the UK for tax, you only pay tax on gains since 5 April 2015.

You can deduct costs of buying, selling or improving your property from your gain.These include:

- estate agents' and solicitors' fees
- costs of improvement works, for example for an extension – normal maintenance costs like decorating do not count.

You cannot deduct certain costs, like interest on a loan to buy your property.

Where you have more than one home you can nominate one as your main residence within two years every time the combination of homes changes. This should be done in writing to HMRC. If no nomination is made, HMRC will decide which property to treat as your main home based on the facts.

No matter how many homes you own or where you lived at the time, you always get relief for:
- the last 18 months before you sold your home
- the first 12 months you owned the home if it was being built, renovated or you could not sell your old home.

You must have lived in the home as your only or main residence at some point while you owned it.You get relief for these periods even if you nominated a different home as your main home.

If you have one home or you nominated your home you get relief if you were away from it for:
- any reason for periods adding up to 3 years
- up to 4 years if you had to live away from home in the UK for work
- any period if you were working outside the UK.

You must have lived in the home before and afterwards, unless your work prevented you.

If you only own one home, you get relief for the last 36 months before you sold your home if any of the following apply:
- you are disabled
- you are in long-term residential care
- you sold the property before 6 April 2014.

If you own more than one home, in most cases, you only get relief for one home for any period.You must work out when you lived in each property as your main home.

If you are married or in a civil partnership only one home per couple counts as your main home for any period.

Where you work from home, you can still get the full amount of relief provided you keep using all of the property as a home, e.g. using a guest bedroom also as an office. If any part of your home is used exclusively for business purposes, this may be liable to CGT.

You may have to pay Capital Gains Tax if you have let out your home. How much you pay depends on how long you lived in it. Having a single lodger does not count as letting out your home. You will pay tax on your 'chargeable gain'. This is your gain minus any Private Residence Relief you are eligible for. You get full relief for:
- the years you lived in the home
- the last 18 months you owned the home – even if you were not living there at the time.

Claim Letting Relief may also be available which could give an additional relief of up to £40,000 (though never greater than any equivalent Private Residence Relief otherwise available on the portion of the property let).

3.3 CGT COMPUTATION

(Please note that these notes relate to chargeable gains of individuals: there are different computational rules for companies, the latter being outside the scope of this course.)

The amount of CGT is based on the gains made from disposals of assets and capital sums received. CGT applies over the same tax year as for Income Tax, i.e. the year ends on 5 April.

If the chargeable gains are less than or equal to the Annual Exempt Amount, an individual will not have to pay any CGT. If the chargeable gains are greater than the Annual Exempt Amount, they will have to pay CGT on the excess.

The amount chargeable to CGT is worked out by listing all the assets disposed of in the tax year. Exempt assets and disposals that are exempt from CGT may be ignored. The disposal of an individual's own home can usually be ignored (see "Principal Private Residence Relief" above).The gain on each asset is then calculated.

There are reliefs available that reduce or defer CGT:

- following the simplification of CGT in the 2008 Finance Act, Taper Relief has been abolished for individuals and Indexation Allowance is now only available to companies
- you may deduct some of the costs of buying, selling and improving assets when working out your gain
- if you have made a loss, you may be able to set that against your gains
- other reliefs are available only in special circumstances (see 3.4 and 3.5 below).

You can then add up the total of your gains less reliefs and allowable losses to calculate your net gains for the year.

Example
Your taxable income (your income minus your Personal Allowance and any Income Tax reliefs) is £20,000 and your taxable gains are £13,000.Your gains are not from residential property.

First, deduct the tax-free allowance from your taxable gain. For the 2019 to 2020 tax year the allowance is £12,000, which leaves £1,000 to pay tax on.

Add this to your taxable income. Because the combined amount of £21,000 is less than £37,500 (the basic rate band for the 2019 to 2020 tax year), you pay Capital Gains Tax at 10%.

This means you will pay £100 in Capital Gains Tax.
[Source: https://www.gov.uk/capital-gains-tax/rates (updated)]

3.3.1 Consideration Received

This will normally be the gross sale price received. However, if the disposal is, for example, by gift, exchange or transfer "other than at arm's length", Consideration Received is taken to be the asset's open market value.

3.3.2 Allowable Deductions

These include:

- original cost of asset
- incidental costs of acquisition such as commission on purchases and legal fees
- subsequent costs of extension and improvement
- costs of protection or preservation of title to the asset
- incidental costs of sale such as commission, legal and valuation fees and cost of advertising.

3.3.3 Rebasing to 31 March 1982

For disposals after 5 April 2008 of assets which were held on 31 March 1982, the normal procedure is that they are re-based to 31 March 1982. This means that the value of the asset at 31 March 1982 is substituted for actual cost of acquiring the asset since this is generally beneficial to the tax-payer: the substituted "starting" value in 1982 is generally significantly higher than the original cost price.

Advisers should be aware that earlier rebasing may have been elected for assets owned on 6 March 1965 when CGT was introduced. Tax advice is desirable in this scenario.

3.4 ENTREPRENEURS' RELIEF

[Sources: https://www.gov.uk/entrepreneurs-relief and HS275 Entrepreneurs' Relief]

Overview and Background

Briefly, Entrepreneurs' Relief (ER) means that tax can be paid at 10% on qualifying assets, instead of the rate of 20% (which would apply for a higher rate tax-payer for non-residential property assets).

Qualification for relief arises on disposal of any of the following:

- all or part of a business as a sole trader or business partner – including the business's assets after it closed;
- shares or securities in a company where at least 5% of shares and voting rights are held (this is known as a "personal company");
- shares obtained through an Enterprise Management Incentive scheme (EMI) after 6 April 2013;
- assets lent to the business/personal company.

Entrepreneurs' Relief was introduced for individuals as a partial replacement for business asset taper relief on certain assets when taper relief was abolished with effect from 6 April 2008 (see final sub-section of 3.5).

A major difference between ER and taper relief is that ER is only available if claimed, whereas taper relief was an automatic entitlement, calculated as part of the CGT disposal computation.

ER applies to disposals of business assets on or after 6 April 2008. When claimed, the relief reduced the gains to which it applied by 4/9ths which effectively reduced the rate of CGT from 18% to 10% on qualifying disposals. This applied to all qualifying gains made up to 22 June 2010. From 23 June 2010 the 4/9ths reduction no longer applies: instead tax is due at 10% on all qualifying gains up to the maximum lifetime limit.

For gains after 22 June 2010 an individual needs to work out their taxable income and see how much of their basic rate tax band is already being used against taxable income.

If you are selling all or part of your business

Both the following must apply:

- you are a sole trader or business partner
- you have owned the business for at least one year before the date you sell it

The same conditions apply if you are closing your business instead. You must also dispose of your business assets within 3 years to qualify for relief.

If you are selling shares or securities

Both the following must apply for at least one year before you sell your shares:

- you are an employee or office holder of the company (or one in the same group)
- the company's main activities are in trading (rather than non-trading activities like investment) – or it's the holding company of a trading group

Either of the following must also apply for at least one year before you sell your shares:

- you have at least 5% of shares and voting rights in the company – if they are not EMI shares
- you were given the option to buy them at least one year before you are selling them – if they are EMI shares

If the company stops being a trading company, you can still qualify for relief if you sell your shares within 3 years.

If you are selling assets you lent to the business

Both the following must apply:

- you have sold at least 5% of your part of a business partnership or your shares in a personal company
- you owned the assets but let your business partnership or personal company use them for at least one year up to the date you sold your business or shares – or the date the business closed

Work out your tax

How you work out your tax depends on whether all your gains are eligible for Entrepreneurs' Relief.

If all your gains qualify for Entrepreneurs' Relief

1. Work out the gain for all qualifying assets.
2. Add together the gains (and deduct qualifying losses) to work out the total taxable gain that's eligible for Entrepreneurs' Relief.
3. Deduct your tax-free allowance.
4. You will pay 10% tax on what is left.

If you have other gains

How much tax you pay on your other gains depends on both:

- what Income Tax rate you pay
- when you made your gain

Higher rate Income Tax payers

You will pay 28% tax on gains made before 6 April 2016 that do not qualify for Entrepreneurs' Relief.
For gains made from 6 April 2016 that do not qualify for Entrepreneurs' Relief you will pay:

- 28% on gains from residential property
- 20% on gains made from other chargeable assets

You can use your tax-free allowance against the gains that would be charged at the highest rates (e.g. where you would pay 28% tax).

Basic rate Income Tax payers

If you are a basic rate taxpayer, you need to work out the tax rate you will pay on gains that are not eligible for Entrepreneurs' Relief.

1. Work out how much taxable income you have – deduct your Personal Allowance and any other Income Tax reliefs to which you are entitled.
2. Deduct this amount from the basic rate tax band for the year you made the gains. This gives you the amount of basic rate band you can use against your gains.
3. Work out your total taxable gain.
4. Use your basic rate band first against any gains eligible for Entrepreneurs' Relief. You will pay 10% tax on these.
5. Use any remaining basic rate band against your other gains. You'll pay 18% on gains made before 6 April 2016. For gains made after this you'll pay 18% on gains made on residential property and 10% on gains from all other chargeable assets.

6. For gains above the basic rate band you will pay 28% on gains made before 6 April 2016. For gains made after this you will pay 28% on gains made on residential property and 20% on gains from all other chargeable assets.
7. You can use your tax-free allowance against the gains that would be charged at the highest rates (e.g. where you would pay 28% tax).

Any unused basic rate band is first allocated against gains that qualify for Entrepreneurs' Relief. After this any remaining basic rate band is allocated against other gains and these are charged at 18%. Any remaining gains above the basic rate band are charged at 28%.

Example – Mrs T's total income, after deducting allowances and reliefs, is £27,000.
Her capital gains, after reliefs, are £20,000: £4,000 of these gains qualifies for Entrepreneurs' Relief.

The basic rate band is £34,500. Mrs T has used £27,000 of this amount against her income, so has £7,500 remaining.

She allocates £4,000 against the gains that qualify for Entrepreneurs' Relief and pays tax on these at 10%.

She allocates the remaining £3,500 basic rate band against her other gains and these are taxed at 18% (or 10% depending on type of asset on which gain is made). Thus far, tax on £7,500 of her gains has been accounted for leaving tax on £13,500 of her gains yet to be calculated

Her annual exempt allowance of £11,700 is allocated to her remaining £13,500 gains. This leaves £1,800 gains taxed at 28% (or 20%).

Further Detail

ER applies to individuals who each have a lifetime limit (*Note: it is a lifetime limit not an annual limit and ER can be used in conjunction with the annual limit*) on the amount of ER individuals can claim on qualifying gains. The limits were:

- the first £1 million on qualifying gains: this applied from 6 April 2008 to 5 April 2010
- the first £2 million from 6 April 2010 to 22 June 2010
- the first £5 million from 23 April 2010 to 5 April 2011.

From 6 April 2011, each individual has an ER limit of £10,000,000.

Trustees can claim this relief when a trust sells or transfers:

- shares in a beneficiary's personal company – but only if the beneficiary is an officer or employee of the company
- assets used in the beneficiary's business – but only if the business is no longer operating and the asset was used for at least 1 year out of the last 3 before the business stopped operating.

The trustees and the beneficiary must make a joint claim. Each beneficiary has a limit of £10 million. This limit is reduced by any ER that the beneficiary has claimed on the sale or transfer of their own assets. As well as paying tax on gains, trustees must work out any losses from the sale or transfer of assets. They must offset these against taxable gains.

If losses in any tax year are higher than that year's gains, they are carried forward and deducted from the next year's gains.

The rationale behind ER, viz. to encourage new investment, is being extended to external investors in unlisted trading companies. This new ***Investors' Relief*** applies a 10% rate of CGT to gains accruing on the disposal of ordinary shares in an unlisted trading company held by individuals, that were newly issued to the claimant and acquired for new consideration on or after 17 March 2016, and have been held for a period of at least three years starting from 6 April 2016. Unlike with ER, the investor does not need to be a director of the company

in which he is investing. A person's qualifying gains for Investors' Relief will be subject to a lifetime cap of £10 million: this is in addition to any ER.

3.5 OTHER RELIEFS

Other reliefs are currently available and include those considered in the following sections. This section also considers loss relief

Business Asset Rollover Relief

Business Asset Rollover Relief is a way for CGT to be deferred if an individual who disposes of an asset used for the purposes of his trade or employment wishes to purchase another business asset. That individual is able to roll over the gain against the purchase price of a replacement asset, where the asset is purchased within 3 years of selling or disposing of the asset (or up to one year before). If all of the sale proceeds are reinvested, the original cost of the new asset (which will be taken into account on a subsequent disposal) is reduced by the gain that would have accrued on the first disposal if Business Asset Rollover Relief had not applied. Thus the gain on the subsequent disposal will be increased by the rolled over gain and a greater amount of CGT will be payable unless, of course, this gain is also rolled over. This relief applies principally in relation to the replacement of business assets: it can also apply at incorporation and disincorporation. Where not all of the money received is reinvested the relief is restricted.

Gift Hold-Over Relief

If a person transfers a business asset to another person for nothing, that is a gift in the strict sense and is a disposal. If a person receives something for transferring an asset but the consideration is less than its market value, this is also a disposal. In both cases this is treated as a disposal for less than market value. Full or partial relief from Capital Gains Tax may be available under these circumstances. Claims for Hold-Over Relief must be claimed jointly with the person you give the gift to.

Example

An individual sells a shop to his brother for £40,000. The shop was then worth £81,000. It cost £23,000. The £17,000 gain (£40,000 less £23,000) is included in the individual's taxable gains. The brother will include the cost when he works out his taxable gain. In the absence of Gift Hold-Over Relief, liability to Capital Gains Tax would be based on the full market value of £81,000.

EIS Deferral Relief

When you dispose of an asset and make a gain you usually pay Capital Gains Tax for the tax year in which you dispose of the asset (it can be any asset). EIS Deferral Relief lets you treat the gain as not arising until some future date if you acquire EIS shares. When you dispose of the asset and make a gain you usually pay Capital Gains Tax for the tax year in which you dispose of the asset. Deferral Relief lets you treat the gain as not arising until some future date if you acquire EIS shares.

If you make a claim to defer a gain, the gain may be charged to Capital Gains Tax in a later tax year, usually when you dispose of the EIS shares. The original gain then becomes chargeable as a separate matter from any gain or loss on the EIS shares. If you obtain Income Tax relief on an acquisition of shares, then you can claim Deferral Relief as well. You do not have to obtain Income Tax relief to claim Deferral Relief.

The EIS shares which are subscribed for must be issued in the period beginning 12 months before, and ending 36 months after, the date of the disposal for which EIS Deferral Relief is to be claimed. (HMRC have discretion to extend these time limits.)

Example
An asset is disposed of on 6 June 2013 making a gain. (It can be a chargeable gain on any type of asset, e.g. on the sale of a second home/property.) EIS Deferral Relief may be claimed against this gain if a subscription for EIS shares is made and these shares are issued at any time between 6 June 2012 and 6 June 2016.
[Source :HMRC Guidance HS297 Enterprise Investment Scheme and Capital Gains Tax]

Points to note in relation to EIS Deferral Relief are:

- the £500,000 maximum subscription limit for EIS Income Tax relief does not apply to EIS Deferral Relief;
- there is no maximum shareholding limit in the new company, therefore an individual may subscribe for EIS Deferral Relief shares in a company that he already owns or controls (for EIS Income Tax relief the individual cannot own more than 30% of the company's shares).

EIS Disposal Relief

If disposal relief is due, Capital Gains Tax on a gain will not have to be paid on the disposal of EIS shares if the following conditions are met:

- EIS shares must be held for at least three years (note that if the shares are acquired in an EIS company which did not start to trade until a later date, the three years do not start until that later date)
- Income Tax relief must have been received in full on the whole of the subscription(s) for the EIS shares and none of the Income Tax relief must have been withdrawn.

Example
£150,000 worth of EIS shares issued by a trading company is subscribed for on 1 June 2009. The maximum Income Tax relief of £30,000 is received. In 2010/11, £10,000 Income Tax relief is withdrawn. EIS shares sold on 1 July 2013 making a gain. Disposal Relief exempts two-thirds of the gain from Capital Gains Tax (two-thirds being the Income Tax relief given and not withdrawn, divided by the full Income Tax relief originally given.)
[Source: HMRC Guidance HS297 Enterprise Investment Scheme and Capital Gains Tax]

Seed Enterprise Investment Scheme Relief

Seed Enterprise Investment Scheme Relief is also available. No Capital Gains Tax is payable on a gain of up to £100,000 if you use a gain to buy new shares in small early-stage companies approved for SEIS. [Source: HMRC Guidance HS393 Seed Enterprise Investment Scheme - Income Tax and Capital Gains Tax reliefs (2016)]

Losses

Allowable Losses for Year

Each chargeable disposal in the year is computed separately but disposals which result in a loss can be set against those which result in a gain.

Trading Losses

Losses made by self-employed individuals or partners as a result of their day to day operations can be set against net capital gains before the annual exemption for the year provided such individuals or partners continue to carry on the trade.

Losses Brought Forward

If as a result of deducting total allowable losses from chargeable gains in the previous year there is a surplus of losses such surplus may be carried forward to the subsequent years.

Taper relief abolished

Taper relief was abolished by the 2008 Finance Act and no longer applies. It had been introduced in 1998 to replace the earlier Indexation Allowance. Taper relief applied to asset disposals between 6 April 1998 and 5 April 2008 and reduced the amount of the chargeable gain according to how long the asset had been held for. The taper was more generous for business assets (up to 75% relief after two years) than for non-business assets (up to 40% relief after ten years).

3.6 SALE OF SHARES

When shares, units in a unit trust, securities and debentures are disposed of or sold it is necessary to calculate capital gains and losses [see also HMRC Guidance HS284 Shares and Capital Gains Tax]. In a straight forward case you need to look separately at each asset disposed of that is liable the CGT and work out each gain or loss, add together the gains and subtract the losses, deduct your tax-free allowance (i.e. the Annual Exempt Amount of £12,000 for the tax year 2019/20) and work out the tax due on the gains that remain.

In some cases shares might be bought in the same company at different times and for different prices. When selling or disposing of some of these shares, an average cost needs to be worked out. All shares acquired before the day the shares were sold or bought, of the same type in the same company, are pooled to create a single asset. This is called a "Section 104 Holding". If shares are held on 31 March 1982 these are included in the Section 104 holding at their value on that date, not at their original cost.

Where you are selling or disposing of shares in the Section 104 holding, how you work out the cost depends on whether all or part of the holding is being sold or disposed of. If the entire holding is being disposed of it is the total cost of the holding. If it is only part of the holding, then a proportion of the total cost is used. Once the proportion of the holding being sold is determined this is multiplied by the total cost of the holding to find the cost of the shares in the Section 104 holding being sold.

Example

Jane has a Section 104 holding of 20,000 shares with a cost of £39,000. She sold 8,000 shares in August 2011, but bought no further shares so all of the shares sold are matched with the Section 104 holding.

The proportion of the shares being sold is 8,000/20,000 = 40%

This is multiplied by the total cost of the holding £39,000 x 40% = £15,600

The cost of the shares sold is £15,600

Care needs to be taken if shares of the same type are re-acquired within 30 days of an earlier sale. "Bed and breakfasting" rules apply which mean that the holding is regarded as continuous and no sale or loss applies; the average purchase price is calculated.

3.7 TRUSTS AND CGT

There are different occasions when a trust may generate a CGT charge, and these will determine who has to pay. We consider them here:

Assets are transferred into a trust – the person who makes the transfer pays unless he makes a claim for Hold-over Relief. In this situation the person who receives the asset will pay CGT when it is sold or transferred.

Trust assets are taken out of a trust – the trustees usually pay if they sell or transfer assets on behalf of a beneficiary. There is no tax to pay in a bare trust if the assets are transferred to the beneficiary because the beneficiary is already "absolutely entitled" to the trust property.

Trustees cease to be UK resident or cease to be liable to pay UK tax – trustees pay CGT based on the market value of the assets of the trust immediately before the change in their residency status.

A beneficiary becomes "absolutely entitled" to some or all of the assets in a trust – the trustees pay CGT based on the market value of the asset on the date the beneficiary becomes entitled.

In some situations assets may be transferred to someone else but CGT is not payable. This includes:
- when someone dies and leaves their assets to a beneficiary or trust
- when someone dies and an interest in possession comes to an end.

CGT is worked out for each tax year and is charged on the total taxable gains after taking into account allowable losses, the trust's Annual Exempt Amount and any relevant costs and relief that can reduce or defer gains (e.g. Gift Hold-Over Relief, Private Residence Relief and Entrepreneurs' Relief).The remaining amount is taxed at the current CGT rate of 28%/18% for trustees.

Trustees must tell HMRC about disposals if either of the following applies:
- the value of the disposal exceeds the Annual Exempt Amount for CGT by 4 times (£46,800) and the trustee has been issued with a Trust and Estate Tax Return
- the trustee is liable to pay CGT.

As mentioned in section 3.1 above, trusts have a tax-free capital gains allowance each year, the AEA. If losses brought forward reduce the capital gains of the year to this level, anything left is carried forward to the next year. Trustees record losses, including those carried forward from previous years, on form SA905 Trust and Estate Capital Gains.

Example
In 2017 to 2018 a trust has capital gains of £12,000 and allowable losses of £15,000. The trustees take the losses away from the gains, leaving no chargeable gains for the year. There's no Capital Gains Tax to pay and unused losses of £3,000 to carry forward to 2018 to 2019.

In 2018 to 2019 the trust has gains of £7,000 and no losses. The trustees only use £1,150 of the previous year's losses to reduce the gain to the level of the trust's AEA - £5,850 for 2018 to 2019.They still have
£1,850 of unused losses left to carry forward to 2019 to 2020.

Source: https://www.gov.uk/guidance/trusts-and-capital-gains-tax updated)

3.8 THE COLLECTION OF CAPITAL GAINS TAX

If an individual receives a tax return and has to fill in the capital gains pages, they should report the disposals and the gain or loss on each disposal by completing the capital gains pages of the return. If they were not sent these pages, they can ask for them from the HMRC Orderline.

If an individual has not received a tax return and needs to report gains or losses, they should contact their Tax Office. If they have gains to report they must give their Tax Office the details by 5 October following the tax year in which the gains arose.

The tax is payable on 31 January after the end of the year for which the gain is assessed.

If an individual is late in sending in a tax return, if they do not tell their Tax Office about gains that should be included in a tax return, or if they do not pay CGT at the right time then they may face a penalty, interest and surcharges.

3.9 EXAMPLES

i) Ken acquired 10,000 Fleet plc shares in June 1991 for 220p per share. He sold the shares in May 2018 for 480p. Ken's costs on the purchase were £400 and on the sale were £500. Fleet plc is not Ken's personal company for Entrepreneurs' Relief purposes and Investors' Relief does not apply. Ken has no accumulated losses which can be brought forward. What are the tax consequences of the sale of shares (assume sale and purchase were at market price)?

The taxable capital gain is calculated as follows:

Sale price		£48,000
less costs		£500
		£47,500
Purchase price	£22,000	
plus costs	£400	
		£22,400
Chargeable gain		£25,100
less annual exemption		£11,700
Taxable gain		£13,400

ii) David acquired a second home in January 1978 (which has never been nominated as his principal home). He paid £25,000.The property is sold in May 2018 for £210,000, out of which David pays estate agents' fees of £2,000 and £1,000 in legal fees & disbursements. Part of the increase in the value of the property can be attributed to the extension he had built in May 1987 at a cost of £20,000. David also acquired an antique picture for £2,000 in May 1992 for his second home. He sells the painting for £5,500 in May 2018.What are the tax consequences of both sales (assume all sales and purchases were at market prices and there are no accumulated losses which can be brought forward)?

The taxable capital gain on the property is calculated as follows:
Since it is his second home it is not his principal private residence and therefore is not exempt.

Sale price		£210,000
less costs		£3,000
		£207,000
Asset held on 31 March 1982		
Rebased value agreed with HMRC	£50,000	
Improvements cost	£20,000	
		£70,000
Chargeable gain		£130000

There is no gain on the disposal of the painting since this is a chattel and the sale price does not exceed £6,000.

iii) Jamie has not made a previous claim for Entrepreneurs' Relief. He operates two separate businesses and decides to sell up. The first business is disposed of on 31 May 2016 and Jamie makes a gain of £440,000 on the disposal of goodwill, but a loss of £80,000 on the disposal of the premises. All the conditions are met for ER. Jamie has already used his Annual Exempt Amount in each year. The gains and losses are aggregated

£440,000 – £80,000 = £360,000

The ER rate of CGT of 10% is due on £360,000 = £36,000

The second business is disposed of on 31 July 2017. Jamie makes gains of £100,000 on the disposal of goodwill and £580,000 on factory premises, but makes a loss of £50,000 on a small warehouse. All the conditions for ER are met. The gains and losses are aggregated

£100,000 + £580,000 – £50,000 = £630,000

The ER rate of CGT of 10% is due on £630,000 = £63,000

iv) Delia sold a pharmacy business in May 2018 and is liable to tax at the higher rate. She realised gains of £12,250,000 and has not previously claimed any Entrepreneurs' Relief. Her available maximum relief is on qualifying gains of £10,000,000, i.e. the whole of her lifetime allowance. The balance of the gains will be liable to the normal rate CGT for non-residential assets (20%). The Annual Exempt Amount for 2019/20 is £11,700.

Total qualifying gains	£12,250,000	
Gains attracting ER rate of CGT at 10%	£10,000,000	
Balance of gains chargeable at "normal" CGT		£2,250,000
Minus Annual Exempt Amount		£ 11,700
Gains chargeable at 20%		**£2,238,300**

v) Cathy had two businesses and disposed of the first in July 2015 realising gains of £6,500,000 all of which qualified for Entrepreneurs' Relief. The second business was sold in May 2016 making gains of £4,900,000. She makes a second claim for ER but only part of the gains will be eligible for relief as this uses up the remaining part of her lifetime limit of ER, which is £10,000,000.

2015/16	
Lifetime limit (as at July 2015)	£10,000,000
Qualifying gain from business 1	£ 6,500,000
Remaining lifetime limit	£ 3,500,000
2016/17	
Qualifying gain from business 2	£ 4,900,000
Remaining ER lifetime limit	£ 3,500,000
Balance of gains charged at "normal" CGT	**£ 1,400,000**

Note: If Cathy has not used the AEA elsewhere it can be deducted from the gain.

HMRC's website provides further information at
https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual

Summary

Capital Gains Tax is governed by TCGA. CGT may arise on the disposal of an asset. A calculation must be carried out on a disposal to work out the potential chargeable gain which may then be subject to a number of reliefs.

Self Test Questions

- What relief might the owner of a business claim on sale?
- A higher rate taxpayer realises a £28,000 gain on the private sale of a Ferrari. Does this disposal give rise to any tax consequences?
- Do shareholders in family companies qualify for any relief from CGT?
- What special rules apply to assets held on 31 March 1982?

INTRODUCTION

Although one might expect from the name of this tax that the imposition of Inheritance Tax (IHT) arises solely on death, Inheritance Tax is actually a tax on transfers made by individuals both in their lifetime and as a result of death. (Perhaps the earlier names for the forerunners of this tax, Capital Transfer Tax and Estate Duty are more apt?) The legislation relating to IHT is to be found in the Inheritance Tax Act 1984 (IHT) and subsequent amendments.

4.1 GENERAL APPLICATION OF IHT

IHT is charged on "chargeable transfers" made by an individual on or after 18 March 1986, be they during lifetime or at death. On certain lifetime transfers called "Potentially Exempt Transfers" (PETs) no liability to IHT arises unless the transferor dies within seven years after making the transfer. On the death of a person, he is treated as if he had made a transfer of value of his "estate" (i.e. wealth) immediately before his death.

Note that where lifetime gifts are chargeable immediately, Chargeable Lifetime Transfers (CLTs) (i.e. do not qualify as PETs), the tax payable initially will be on the basis of half the current death scale rates. Upon death within seven years the tax payable must be recalculated at the full death rate though certain additional reliefs may be available.

Contrary to the treatment of other taxes, which are aggregated for a fiscal year and then charged to tax, IHT is calculated on the "cumulation" of chargeable transfers over a seven year period. Each transfer is cumulated chronologically (i.e. each time a gift is made) over the seven year period. This means that a chargeable transfer is added to all previous chargeable transfers made in the preceding seven years. Note also that a CLT made up to 14 years before a settlor's death could affect the IHT liability on a later failed PET. This is because if a PET fails and becomes chargeable, the IHT calculation on that failed PET must take into account CLTs made by the donor in the seven years before the making of the PET.

Once the running total reaches the top of the nil-rate band, £325,000 per person until 2020/21, the latest chargeable gift is taxed on the amount by which the running total exceeds the nil-rate band. After seven years transfers drop out of an individual's running total.

4.2 DEFINITIONS

4.2.1 Estate

An individual's estate includes:

- everything owned in his name
- the share of anything jointly owned
- assets held in trust from which he gets some personal benefit, for example, an income
- gifts from which he keeps back some benefit – for example, a house still lived in, although given to somebody else
- life assurance policy proceeds
- pensions – possibly, the provider should be asked to confirm if there is any value due to the Estate (bear in mind that pension schemes are normally set up under a discretionary trust and that no value accrues to the Estate on death).
- funeral expenses, debts and liabilities (which of course reduce the Estate's value) – debts and liabilities may include mortgages, loans, overdrafts, credit card balances and unpaid household bills including bills for goods and services

When a person's Estate is valued, a realistic market value needs to be assessed which generally involves the use of a professional valuer for items worth more than £500. An estimate may be made for smaller value items.

4.22 Chargeable Transfer

A chargeable transfer is a "transfer of value" which is made by an individual and which is not an "exempt transfer". Inheritance Tax is charged on the value transferred by a chargeable transfer.

4.23 Transfer of Value

The value transferred, a disposition in IHT parlance unless the transaction was at arm's length or no transfer of value was intended (latter being an easement under s10 of ICTA'84), is not necessarily the amount of value received by the transferee; it is the reduction in value of the transferor's estate, which is not always the same as the value given away. A simple example illustrates this: assume Frank has a rare, complete 1930 Hornby model train set worth £25,000 and gives his son Nick the locomotive out of the set. The loco is valuable in itself, worth £3,000 but the set that Frank retains is now incomplete and would only be worth £8,000 at most. Therefore Frank has reduced his estate by £17,000 and that is the amount potentially subject to IHT.

The same principles can apply to transfers of shares. For example a gift of 2% of shares which reduces a holding from 51% to 49% will have a much higher value for IHT than a 2% shareholding viewed in isolation because it has reduced the donor's holding from one that gives day to day control over the company into one that may be overruled and so is worth less.

For the purposes of determining IHT liability the amount of any transfer is determined by the value lost by the donor's estate, which is not necessarily the value of the transfer gained by the transferee.

4.24 Excluded Property

Property is chargeable unless it is excluded (or "exempt" – see next section). Examples of excluded property under the IHTA include:

- property (absolutely owned and not in a settlement) situated outside the United Kingdom if the person beneficially entitled to it is an individual domiciled outside the United Kingdom;
- property held in a settlement if the settlor was domiciled outside the UK when he made the settlement, and the settled property is not situated in the UK;
- holdings in an authorised unit trust and an open-ended investment company if the person beneficially entitled to it is an individual domiciled outside the United Kingdom;
- rights in the following where the person beneficially entitled is domiciled in the Channel Islands or the Isle of Man, the following being:
  (a) war savings certificates;
  (b) national savings certificates (including Ulster savings certificates);
  (c) premium savings bonds;
  (d) deposits with the National Savings Bank or with a trustee savings bank;
  (e) a certified SAYE savings arrangement within the meaning of section 703(1) of the Income Tax (Trading and Other Income) Act 2005;
- Decorations, medals and awards.

4.25 Exempt Transfers

Certain transactions and gifts, regardless of the type of property they are, are not regarded as transfers of value. Hence even when a transfer of property which is not excluded property takes place, exempt transfers do not attract IHT.

Exemptions applicable to lifetime transfers include:

- dispositions for family maintenance – such as between spouses (including provision on divorce), to children up to the completion of their education and to dependent relatives

- transfers allowable as expenditures for Income and Corporation Tax or conferring retirement benefits – in most cases these are not gratuitous but they also include, for example, both the employee's and employer's contributions to registered pension schemes. Contributions to non-registered (employer-financed) schemes and other arrangements are also covered by this exemption if they do not exceed an amount comparable with the limits on registered schemes and are not made in respect of connected persons
- normal expenditure out of income – such transfers must be gifts made purely out of income as part of a person's normal expenditure. The claimant must show that after allowing for the gifts the transferor was left with sufficient income to maintain his usual standard of living and that there was an established pattern of giving
- annual exemption – an exemption of £3,000 is available which, if not used in the current tax year, may be carried forward for one year only, if the subsequent year's allowance has been fully utilised. A husband and wife each have a separate allowance
- small gifts exemption – any number of gifts is allowed up to a value of £250 per fiscal year per person (but not for anyone who has received the £3,000 annual exemption amount)
- gifts made in consideration of marriage, provided the value of the gift does not exceed £5,000.This includes outright gifts by a parent to a party to a marriage.

The following transfers during lifetime or at death are also exempt:

- transfers between husband and wife provided both spouses are of UK domicile (or deemed to be of UK domicile). Individuals are deemed to be of UK domicile if they have been resident in the UK for 17 out of 20 years ending with the current year. From 5 December 2005, couples in civil partnerships are treated in the same way as married couples for IHT purposes
- gifts for national purposes to national institutions (e.g. The National Gallery, The British Museum and similar national institutions)
- gifts to charities – unlimited during lifetime, exempt on death unless dependent on a condition not satisfied within one year of the transfer/disposition.
- gifts to political parties – the party must have had at least two MPs elected at the last General Election or have one MP and a total vote for all candidates of that party of at least 150,000 votes.

Conditional exemptions:

- asset qualifies for Business Relief (which is the new name for what is still widely referred to as Business Property Relief), Agricultural Relief or Woodland Relief
- the Treasury may designate property as exempt from IHT if certain conditions are met and undertakings given (e.g. as regards to location, upkeep and access to the public are observed).This covers qualifying heritage assets such as chattels of museum quality, land and buildings of outstanding scenic, historic or scientific interest.

4.26 Chargeable Lifetime Transfers (CLT)

All transfers of value paid into trusts (other than bare trusts and certain trusts for disabled persons) are chargeable lifetime transfers. Previously, transfers to accumulation and maintenance trusts and interest in possession trusts were regarded as Potentially Exempt Transfers (see below). With effect from 21 March 2006 all newly settled trusts other than bare trusts and disabled trusts are "Relevant Property" trusts and subject to IHT on settlement and every ten years under the principal charge provisions.

The tax payable on a CLT is calculated on the reduction to the settlor's estate made by the transfer as follows:

- apply any reliefs applicable to the property at the time of transfer (i.e. Business Relief or Agricultural Property Relief);
- deduct any available exemptions (effectively the current and previous year's £3,000 annual exemptions)
- deduct any available nil-rate band of the transferor (NB this cannot include any Transferable Nil-Rate Band (TNRB) (see 4.3) from a deceased spouse or civil partner: TNRB is only available to set against transfers on death)
- IHT is charged at 20% (i.e. 50% of the full rate on death) on the balance.

4.2.7 Potentially Exempt Transfers (PETs)

A Potentially Exempt Transfer is a lifetime transfer of value made by an individual on or after 18 March 1986 comprising one of the following:

- a gift to another individual
- a transfer into a trust for the disabled which is not otherwise covered by an exemption.

PETs are exempt transfers unless the transferor dies within seven years. As a result there is no liability to IHT at the time of the transfer. If the transferor dies within seven years, the gift becomes taxable and treated as made at the time of the original transfer but with the rates of tax at the date of death being applied, subject to a tapering relief depending on the number of years between gift and death.

When an individual dies, the value of any PETs made in the previous seven years is added to the value of the estate. This could affect the amount of tax charged on other assets because they are then treated as forming the top part of the estate. An example of how taper relief applies in such circumstances is given below.

If a lifetime transfer of value does not fall within the exemptions above, then it is immediately chargeable to IHT (e.g. a transfer of property into a trust). In many cases the transfer will need to be grossed-up so that the discretionary trust receives the desired amount after IHT has been deducted. If a transfer (perhaps a legacy under a person's will) is stated to be "free of tax" this means that it should be grossed-up. As previously indicated where death occurs within seven years the tax payable must be recalculated at the full death rate (subject to any further reliefs – see below) with any further tax due being paid by the trustees of the settlement or the deceased's personal representatives.

4.3 RELIEFS

After computation of liability the actual IHT payable may be reduced by the following 'Reliefs'.

4.3.1 Taper Relief

This gives relief to transfers made within seven years of death on the liability arising by reason of the death by reducing the amount of IHT payable. The Taper Relief reductions are as follows:

Time between the date the gift was made and the date of death	Taper relief percentage applied to the tax due
3 to 4 years	20%
4 to 5 years	40%
5 to 6 years	60%
6 to 7 years	80%

Example

Joe made a gift of £350,000 on 15 January 2014. He died on 15 April 2017. The Inheritance Tax threshold for the year he died is £325,000. Follow the steps below to work out the Inheritance Tax due:

Step one: take away the threshold from the value of the gift: £350,000 – £325,000 = £25,000. So Inheritance Tax is due on £25,000

Step two: work out the Inheritance Tax at 40%: £25,000 x 40% = £10,000

Step three: the gift was made within three to four years of death. So Taper Relief at 20% is allowed: £10,000 x 20% = £2,000

Step four: take away the Taper Relief from the full tax charge: £10,000 – £2,000 = £8,000

Taper Relief reduces the amount of tax payable from £10,000 to £8,000.

- **Successive Charges Relief (also known as Quick Succession Relief)** – where a person dies within five years of a transfer to him which increased the value of his estate, tax payable on death is relieved by a percentage of the tax paid on the original transfer according to a sliding scale. The relief reduces the tax payable on the second transfer by a percentage of the tax paid on the first transfer as follows:

Years between the two transfers	Percentage reduction
1 year or less	100%
1 to 2 years	80%
2 to 3 years	60%
3 to 4 years	40%
4 to 5 years	20%
Over 5 years	0%

The formula used for calculating relief is:

Increase in estate / value of the earlier transfer x tax on the earlier transfer x % reduction

Example
Aled died in May 2009 and left a legacy of £100,000 out of his estate of £300,000 to his sister Bronwen. Inheritance tax of £23,200 was paid on the death of Aled.

Bronwen died in July 2013, leaving her whole estate of £450,000 to her daughter Eluned. Inheritance tax is payable on Bronwen's estate. The Inheritance Tax due on Bronwen's estate will be reduced by Successive Charges Relief as follows:

Increase in Bronwen's estate / value of Aled's estate x tax on Aled's estate x 20%

i.e., £100,000 / £300,000 x £23,200 x 20% = **£1,546.66** Successive Charges Relief

Bronwen's estate	£450,000.00
less IHT threshold	£325,000.00
Total	**£125,000.00**
IHT at 40% before relief	£50,000.00
less Successive Charges Relief	£ 1,546.66
Tax due on Bronwen's estate	**£48,453.34**

- **Relief for tax paid abroad**– where a person dies with assets in a country with a double taxation agreement with the UK and their assets abroad are liable for tax abroad.

- **Relief for gifts which have lost value** – if the Executor believes a gift has lost value between date of transfer and date of death then the Probate Office may agree to admit a claim for relief on the loss.

432 Transferable Main Residence Relief

In 2010, George Osborne indicated his intention to raise the IHT threshold to £1,000,000. However, the Coalition Government froze it at £325,000, the 2009 level. In July 2015's Summer Budget, the Chancellor brought in a new transferable main residence allowance, provided a Qualifying Residential Interest (QRI) existed in the property. For a QRI to exist a person must have lived in the property for which the transferable main Residence Nil-Rate Band (RNRB) is being claimed.

RNRB increases in £25,000 steps each year from £100,000 at its April 2017 start date to £175,000 per person by 2020/21: CPI increases will apply for subsequent tax years. Given also the availability of spousal transfers, this equates to £1,000,000 in aggregate, provided that the main residence is worth at least £350,000. It will be available where the home is inherited by direct descendants: the term "closely inherited" is ascribed if this applies.

If the net value of the estate is above £2 million, this additional nil-rate band will be tapered away by £1 for every £2 that the net value exceeds that amount. The taper threshold at which the additional nil-rate band is gradually withdrawn will rise in line with CPI from 2021 to 2022 onwards.

Properties left to a discretionary trust will not benefit from the main residence allowance, although an absolute appointment to a beneficiary who can be regarded as "closely inheriting" made either by settlor before death or by trustees within two years following settlor's death will enable the main residence allowance to be utilized.

433 Transferable Nil Rate Band (TNRB) on Deaths after 8 October 2007

New rules were introduced by the 2008 Finance Act to allow any unused IHT nil-rate band (£325,000 in 2019/20) to be transferred to the estate of a surviving spouse or civil partner who dies on or after 9 October 2007.This applies where the nil-rate band of the first deceased individual was not fully used in calculating the IHT liability of their estate. When the surviving spouse or civil partner dies the unused amount may be claimed and added to their own nil-rate band.

It does not matter when the first spouse died, or how many times they were widowed.

The amount ofTNRB that can be claimed is based on the proportion of NRB unused on the earlier death.Therefore if the first spouse uses half of their NRB the amount that can be claimed on the survivor's death is equal to half of the NRB limit in force when the survivor dies.Where a person has inherited more than one unused NRB they are limited to one additional nil-rate band up to the maximum applicable in the year when the last death occurs.

Example

i) Victor died in June 2000 when the NRB limit was £234,000. He had made a lifetime gift of £117,000 in 1995. His widow, Margaret died on 5 April 2015, leaving an estate of £300,000. In 2012 she made an outright gift of her holiday cottage worth £200,000 to her daughter.

Without TNRB the total assessable as a result of Margaret's death would be:

		£
own estate		300,000
failed PET		200,000
Total Estate		500,000
Own NRB		– 325,000
Chargeable at 40%		175,000

But if the TNRB is claimed the situation becomes:

Total Estate		500,000
Deduct own NRB	325,000	
TNRB 50%*	162,500	
		– 487,500
Taxable		12,500

**50% is used because £117,000 is 50% of £234,000 NRB at his death*

Claiming TNRB

The primary entitlement to claim TNRB resides with the executors of the estate but if they do not make a claim the daughter can do so.

4.4 EXAMPLES

i) Christopher dies on 16 April 2017 leaving an estate valued at £600,000 to his two sons. He was divorced from their mother and had not remarried and had made no previous gifts.

Value of estate at date of death £600,000
This is a chargeable transfer to which no exemption is applicable, note the annual exemption (£3,000) does not apply on death.

	£
Cumulative total before death	0
Cumulative total after death	600,000
Less nil-rate band (2017/18)	325,000
Chargeable to IHT at 40%	275,000
Tax due £275,000 at 40%	110,000

Tax payable by personal representatives within six months after the end of the month of death but must in any event be paid before grant of representation is obtained.

ii) Helen, who had never married, died on 1 July 2017 leaving an estate valued at £300,000 to her only daughter. On 1 June 2013 she had given her daughter a house valued at £350,000. She had made no previous gifts.

1 June 2013 transfer is a transfer of value which is a PET. No tax is payable immediately but a charge to IHT arises on 1 July 2017 because Helen dies within seven years of the gift.

Tax payable in respect of PET:

	£
Transfer	350,000
less annual exemptions 2012/13 and 2013/14	
(£3,000 + £3,000 re lifetime gift)	6,000
	344,000
Cumulative total before 1 June 2013 gift	0
Cumulative total after 1 June 2013 gift	344,000
less post 6 April 2017 nil-rate band	325,000
Chargeable to IHT at 40%	19,000
Tax due (before taper relief) £19,000 at 40% =	7,600
Less taper relief: 40% of full amount of IHT payable	3,040
Tax due	4,560

Tax payable by the donee (daughter) in respect of balance of Estate.This becomes payable six months after the end of the month of death. Failing payment by the donee, the liability falls on the personal representatives.

	£
Value of estate at date of death	300,000
Cumulative total before death (PET)	344,000
Cumulative total after death	644,000
nil-rate band is already used up	
Chargeable to IHT at 40%	300,000
Tax due £300,000 at 40%	120,000

Tax payable by personal representatives within six months after the end of the month of death but must in any event be paid before grant of representation is obtained.

iii) Roderick died on 19 June 2017 leaving an estate valued at £700,000 after the deduction of liabilities. He leaves £45,000 to the RNLI in his will.To see if the estate qualifies for reduced IHT due to the charitable donation the following steps must be followed.

Step 1 – deduct the £45,000 RNLI donation from £700,000 (the net estate). This leaves a figure of £655,000.

Step 2 – deduct £325,000 (IHT nil band rate) from £655,000.This leaves a figure of £330,000.

Step 3 – add £45,000 (the value of the donation) back to £330,000.This gives a figure of £375,000 – the "baseline amount".

10% of the estate of £375,000 is £37,500.This estate qualifies for the reduced rate of IHT because the charitable donation of £45,000 is more than 10% of the "baseline amount".

IHT at 36% reduced rate	£330,000 x 36% = £118,800
(compared to IHT paid at full rate of 40%	£330,000 x 40% = £132,000)

4.5 IHT COMPUTATION

The following series of questions will help to determine the IHT payable if a chargeable transfer has taken place.

- Is there a transfer of value?
- Is the transfer excluded property or covered by one of the exemptions (i.e. the exemptions listed in 4.2.5 above)?
- If a lifetime transfer, is the gift a PET (see 4.2.7 above) or immediately chargeable, a CLT (see 4.2.6 above)?
- Following death, are there any PETs which become chargeable and were there any CLTs which must be recalculated (i.e. in the seven year period preceding the date the PET was originally made)?
- Apply (or where appropriate re-apply) tax as above in respect of the PETs and CLTs at the death scale rate.
- Apply Taper Relief, Successive Charges Relief or other reliefs if appropriate.

Position before Death

Assuming there is an immediately chargeable transfer the process is:

- determine the amount of the transfer of value
- deduct agricultural or business property reliefs as appropriate
- deduct the annual exemptions available
- cumulate with other chargeable transfers within the last seven years
- apply the IHT scale rate for lifetime transfers
- decide by whom and when the tax is payable.

Position on Death

To calculate whether any Inheritance Tax (IHT) is payable when an individual dies, it is necessary to:

- identify everything in the "estate"
- deduct agricultural or business property reliefs as appropriate
- take out any items which are exempt or excluded
- add in any non-exempt gifts made within seven years of the deceased's death (and up to 14 years if a PET has failed because of death within seven years) and any gifts in which the deceased had retained an interest
- value these items which form the taxable estate
- deduct any allowable deductions
- apply the IHT threshold to the value of the taxable estate and calculate the tax on any excess.

IHT is payable at the following rates in respect of chargeable transfers on or after 6 April 2009:

Lifetime Transfer
Cumulative value of chargeable transfers Rate of tax
£0 to £325,000 Nil
£325,001 and over 20%

Transfer Chargeable on Death
Cumulative value of chargeable transfers Rate of tax
£0 to £325,000 Nil
£325,001 and over 40%

From 6 April 2012, people who leave 10% or more of their net estate to charity can choose to pay a reduced rate of IHT of 36%.The details of this where trusts and joint ownership are involved can be quite complex and are best referred to tax specialists in this area.

Calculating IHT liability consists of four key steps:

- **Step 1**. First set the amount of the earliest chargeable transfer (that is, any gift ignoring exempt items) within seven years of death against the amount of the IHT nil-rate band or "threshold".
- **Step 2**. Repeat Step 1 for the amount of each later transfer, taking each time what is left of the threshold.
- **Step 3**. If the CLTs amount to less than the threshold, then any unused part of the threshold can be applied to the estate.
- **Step 4**. Once the threshold has been fully used up, any remaining amount of the transfers is now taxable at 40% unless it qualifies to pay the reduced rate of 36% (in other words, tax is charged on the proportion of the estate which is not covered by the nil-rate band).

4.6 PAYMENT OF IHT AND ADMINISTRATION

The assessment and collection of the tax is in the hands of HMRC Capital Taxes.

In general, all individuals who make a chargeable transfer are obliged to send to HMRC a form which details the value of the property forming the transfer within 12 months of the end of the month in which the transfer is made or, if later, within three months beginning with the date on which the individual becomes chargeable to tax.

The general rule for payment of IHT is that it is due six months after the end of the month in which the transfer is made or first becomes chargeable to tax.This latter rule applies in the case of PETs if the transferor dies within the seven year period (known as "failed PETs").

This timescale is varied for immediately chargeable lifetime transfers made between 5 April and 1 October, when the date for payment is 30 April of the following tax year.

IHT is due six months after the end of the month in which the death occurred. The personal representative must pay the Inheritance Tax they are liable for on the deceased's estate before they can get the "grant of representation", even if this is before the end of the six month period.

IHT on failed PETs is also due six months after the end of the month in which death occurred.

The personal representatives of a deceased person must deliver to HMRC an account of all property which formed part of the deceased's estate immediately before death together with details of lifetime transfers made with seven years of death.The account must be presented at the probate registry and any tax payable on delivery paid before a grant of representation can be obtained.

HMRC can ask to see records up to 20 years after Inheritance Tax is paid so Executors need to keep copies of any:

- Will
- copies of signed Inheritance Tax forms and supporting documents
- records showing how you worked out the value of assets in the estate, e.g. an estate agent's valuation
- documents showing any unused Inheritance Tax threshold that can be transferred to a surviving spouse or civil partner
- final accounts.

4.7 GIFTS WITH RESERVATION OF BENEFIT

On death IHT is charged on assets held in a deceased person's estate and on certain assets held on interest in possession trust for their benefit.

The estate is also deemed to include any property that the deceased gave away before death but in which they reserved a benefit. A benefit is reserved in any case where the donor of the asset:

- retains the right to use or enjoy an asset; or
- actually uses or enjoys the benefit of the asset.

A gift with reservation of benefit (GWROB) also arises where the recipient of the gift does not take full possession of it from the donor.

HMRC is prepared to overlook occasional incidental enjoyment, such as where a house is given away and the donor makes occasional visits to the recipient or views a painting on visits to the donee.

Where a GWROB is made there is not a Potentially Exempt Transfer at the time of the gift. If the donor stops enjoying the benefit of the property a PET is deemed to take place at the time when enjoyment ceased and the seven year PET waiting period begins then.

4.8 PRE-OWNED ASSETS TAX

The Pre-owned Assets Tax (POAT), or Pre-owned Assets Charge, was introduced with effect from 6 April 2005 and imposes an Income Tax charge where cash or other assets have been given away.The purpose of the POAT was to counteract schemes designed to avoid IHT. POAT does not remove the IHT benefits of such schemes: instead there is an additional Income Tax charge on the benefit of use of assets that are subject to POAT.

POAT applies where:

- a person has given away assets or cash
- the value of the gift will be outside of the donor's estate for Inheritance Tax purposes, and
- the donor enjoys or is capable of enjoying some benefit from the cash or assets given away.

Where an asset is subject to POAT the former owner is taxed on the "benefit in kind" value of the use of the asset. POAT can only be avoided by paying full market rent for the use of the asset or electing for the asset to be treated as remaining part of the former owner's estate for IHT purposes under the gift with reservation of benefit rules.

4.9 TREATMENT OF BENEFITS ARISING FROM PENSION SCHEMES

A pension or annuity under a registered pension scheme which terminates on death is not treated as part of an individual's estate on death (IHTA'84 s151). Cash options under registered schemes do not prevent a dependant's annuity from being excluded property.

Lump sum benefits (such as refunds of contributions, lump sum death benefits or lump sum payments on death during the guaranteed period of a pension or annuity) are not aggregated with the value of the estate on death provided the member had no general power of disposal.To achieve this, the rules of the scheme will normally state that distribution of lump sum benefit is by the trustees exercising discretion among groups of dependants, relatives, personal representatives and nominees identified in the scheme rules.

The funds, despite being discretionary trusts, are not liable to the charge levied on capital distributions from discretionary trusts nor are they liable to the periodic charge levied every ten years on discretionary trusts.These are charges normally levied on discretionary trusts to limit their use as vehicles for the avoidance of IHT.A lump sum arising on a scheme member's death however does need to be distributed within two years otherwise HMRC will treat it as an unauthorised payment subject to tax.

Although it is not legally permissible for a member to alienate his right to a pension, it is possible to place death benefits on trust for another individual (e.g. a dependant). The gift of a "return of fund" is normally regarded by HM Revenue & Customs as not subject to tax, provided the individual is in good health at the time of making his contributions. (Note: tax can arise on death under pension drawdown contracts where the member is over 75 or has taken part of his benefits, but that is a specialist area (considered in Retail Advice and Regulation) and has been relaxed so that tax will only arise where the deceased member is over age 75.)

While the general view is that pensions and associated death benefits are free from IHT and while there is very little information in the PTM about IHT, care does need to be taken, even where members are not yet 75.Tax Inspectors do try to collect IHT when they have had chance to review data included on the IHT 409 form which Executors need to send to HMRC on a member's death, particularly if they can see an opportunity for a possible charge.The Labour Party has from time to time looked closely at pensions schemes as a means for the wealthy to avoid tax including IHT and although drawdown contracts can now cascade wealth down the generations will this facility remain into the distant future? No-one knows of course but meantime, perhaps because of the political background, individual Tax Inspectors will endeavour to seek ways to impose an IHT charge. IHTA'84 at s3 (1) defines an action as a transfer of value, while s3 (3) defines an omission to take an action as giving rise to a transfer of value. Consequently we can see cases like Arnold in 2010, and Staveley in 2014 where protracted litigation has followed from members' deaths while still in their 50s. A key point to note is that if death occurs within 2 years of a transfer being made by someone in serious ill health, HMRC may well challenge.

4.10 TRUSTS AND IHT

There are four main situations when IHT may be due on trusts (and remember that IHT does not arise only on death) [Source: https://www.gov.uk/trusts-taxes/trusts-and-inheritance-tax]:

- when assets are transferred (settled) to a trust
- when a trust reaches a 10-year anniversary of when it was set up (heritage property is exempt)
- when assets are transferred out of a trust (known as exit charges) or when a trust ends
- when someone has died and a trust is involved in sorting out their estate.

IHT is only due, however, if the assets in the trust are valued above the IHT threshold (£325,000 in 2019/20) and it contains "relevant property". Relevant property includes money, shares, houses and land. If a person has a "qualifying interest", for example a disabled person living in a property then this can be excluded from "relevant property".

When relevant property is transferred out of a trust, an IHT exit charge is made of up to a maximum of 6% on the assets being transferred out of the trust.This exit charge is not made:

- on payments by trustees of cost or expenses incurred on assets held as relevant property
- on some payments of capital to the beneficiaries where Income Tax will be due
- when assets are transferred out of the trust within three months of setting up the trust or within three months of the 10-year anniversary
- when assets are excluded property – e.g. foreign assets where the settlor lives permanently abroad.

When the beneficiary of a trust dies any income or assets in the trust that he is entitled to become part of their estate and the personal representative will need to calculate whether any IHT is due. Also, someone might ask in their Will that, when they die, some or all of their assets are placed in a trust, i.e. a "Will Trust".The personal representative must make sure that the trust is set up properly and that all taxes are paid on the assets going in to the trust. Once it is set up the trustees will be responsible for ensuring that IHT is paid on any further transfers into or out of the trust.

Summary

Inheritance Tax is governed by IHTA. IHT may arise on the death of an individual or on certain transfers of assets during their lifetime. Inheritance Tax on death is calculated by reference to the transfers made during the previous seven years. A number of reliefs reduce the effect of the tax.

Self Test Questions

- What is an IHT chargeable transfer?
- List two transfers which are exempt whether made during lifetime or on death.
- What is a PET?
- What is a gift with reservation of benefit?
- Give an example of a chargeable lifetime transfer.
- What is taper relief in relation to PETs?
- How did the IHT nil-rate band rules change from 9 October 2007?
- When is IHT payable?
- What is POAT?
- When might HMRC challenge for IHT on death under a pensions contract?

INTRODUCTION

There are two main types of stamp duty – stamp duty on land and stamp duty on shares and other securities. Depending on the value of the land or property being sold, the stamp duty payable on these transactions can be significant, with the highest rate normally being 7% of the value of the transaction where the property is a residential property valued at over £2 million.

Stamp duty on shares and other securities is not as significant, but does affect the cost of investing.

5.1 STAMP DUTY LAND TAX

Stamp Duty Land Tax (SDLT) is payable if on the purchase (or transfer) of a property in the UK over a certain price. This is charged on all purchases of houses, flats and other land and buildings. (Different rates have applied in Scotland since 1 April 2015 when Land and Buildings Transaction Tax replaced SDLT. From 1 April 2018, SDLT is replaced in Wales by Land Transaction Tax)

The SDLT rate depends on:

- the purchase price of the property
- whether the property is residential

SDLT is now charged at different rates depending on the portion of the purchase price that falls into each rate band. Before 4 December 2014, SDLT was charged as a single percentage of the overall property price, referred to as the "slab" system and often criticised as introducing distortions in the market. The pre-04/12/14 single percentage SDLT rates increased with the value of the transaction, as is shown in the table below (applicable to purchasers buying their own property i.e. not a corporate purchaser).Therefore any property selling at just above an SDLT band experienced a significant jump in SDLT. Thus a property selling for £125,000 paid no SDLT but a selling price of £125,050 meant that SDLT of £1,250 (rounded to lower £) was due.

Residential land or property SDLT rates and thresholds 25 March 2010 to 3 December 2014	
Purchase price/lease premium or transfer value	**SDLT rate**
Up to £125,000	0%
£125,001 to £250,000*	1%
£250,001 to £500,000	3%
£500,001 to £1,000,000	4%
£1,000,001 to £2,000,000	5%
Over £2,000,000	7%

* between 25 March 2010 and 24 March 2012 the SDLT threshold for first time buyers was £250,000, i.e. for properties up to the value of £250,000 the SDLT rate was 0%.

Following the Chancellor's Autumn Statement on 3 December 2014 the new rates in the following table apply. Where contracts had been exchanged on or before 3 December 2014, and the transaction was completed on 4 December or later, transitional easement allowed the choice as to whether to use the old rates (above) or the new rates (see table below). So for the property selling for £125,050, SDLT of £1 (rounded to lower £) becomes due.

SDLT is payable:

- on purchasing a freehold property
- on purchasing a new or existing leasehold
- on purchasing a property through a shared ownership scheme
- on transferring land or property in exchange for payment, e.g. taking on a mortgage or buying a share in a house

The current SDLT threshold is £125,000 for residential properties. The table below gives the rates for residential properties

Residential land or property SDLT rates and thresholds from 3 December 2014	
Purchase price of property	**Rate of SDLT (percentage of portion of purchase price)**
£0 - £125,000	0%
£125,001 - £250,000	2%
£250,001 - £925,000	5%
£925,001 - £1.5 million	10%
Over £1.5 million	12%

SDLT surcharge/Higher Rate. From 26 November 2015 an extra 3% SDLT is payable if you are exchanging contracts on an additional property (buy-to-let or your own second home) and had not completed by 31 March 2016. If you are moving home and temporarily own two properties for less than 36 months, a refund of the surcharge may be available.

For corporate bodies, "non-natural persons" like companies and collective investment schemes SDLT is charged at 15% on residential dwellings costing more than £500,000.

Different rates apply for non-residential properties and mixed use properties (a mixed use property is one that incorporates both residential and non-residential elements). Non-residential property includes:

- commercial property such as shops or offices
- agricultural land
- forests
- any other land or property which is not used as a dwelling
- six or more residential properties bought in a single transaction.

The rates of SDLT for these properties also depend on whether the property is freehold or leasehold, but this data are outside the scope of this course.

Between 1 December 2003 and 5 April 2013, where a property was in an area designated by the Government as "disadvantaged", the zero rate for SDLT applied up to a purchase price of £150,000. All claims for this relief must have been made before 6 May 2014.

SDLT is not payable on any part of the purchase price that is attributable to such things as carpets, curtains and any other items which the vendor leaves in the property.

When land or a property is purchased or transferred, where applicable a SDLT return must be completed and any tax due paid within 30 days of the "effective date" of the transaction. The return is required for residential properties selling for more than £40,000 even if less than £125,000 when it will be a "nil" return. The effective date is normally completion, i.e. when the majority of the purchase price is paid, but if the purchaser is entitled to take possession of the property before completion, it will be the date that the purchaser is entitled to take possession.

Some transactions are exempt from SDLT. In most cases, when property is left to another person in a will it is exempt from SDLT. Also, when a couple get divorced, separate or end their civil partnership, and the parties agree to split their property and land between them, or the property is split under the terms of a court order, it is exempt from SDLT.

5.2 STAMP DUTY RESERVE TAX AND STAMP DUTY

When buying shares you pay either Stamp Duty Reserve Tax (SDRT) or Stamp Duty (SD) depending on the type of transaction it is. SDRT is payable on electronic, paperless transactions and it is automatically deducted when the transaction is made. SD is payable on paper transactions, e.g. when using a stock transfer form. SD is only paid when the shares are transferred, not when they are first issued.

Stamp Duty Reserve Tax

The amount of SDRT paid is worked out on a flat rate of 0.5% (rounded up or down to the nearer penny) based on what you give for the shares, not what the shares are worth. If it is a cash transaction the amount of SDRT is based on the amount of cash paid. If you give something else of value it is based on the value of the thing given.

HMRC need to be notified about the transaction by the due date which is the seventh day of the month after the month in which electronic transaction took place. The initial penalty for failing to notify is £100 which increases after 6 months and again at 12 months.

The broker acting for the purchaser is normally responsible for paying SDRT to HMRC and the amount payable will be shown as a deduction on the stockbroker's contract note.The electronic transactions affected are largely those dealt with on the CREST system or in off-market transfers.

SDRT on OEICS and Unit Trusts purchase was removed with effect from 30 March 2014. Announced in the 2013 Budget, it was introduced to make the UK a more competitive financial marketplace.

The purchase of a new issue of shares is now recognised by HMRC as outside of the scope of the SDRT tax charge. EU Council Directive 2008/7/EC requires the free movement of capital without the levy of indirect taxes

Stamp Duty

Share transfers that are valued at £1,000 or less do not normally have to pay any SD.The exemption certificate on the back of the stock transfer form needs to be completed and sent, together with the share certificate, to the registrar of the company which issued the shares. If a share transfer with a value of £1,000 or less was agreed and signed before 13 March 2008, the stock transfer form needed to be stamped by HMRC and stamp duty was payable.

Where share transfers are valued at more than £1,000 SD is payable. This means that the stock transfer form, together with the appropriate payment, must be sent to HMRC for stamping. The amount of SD payable is based on the "consideration" given for the stocks or shares. Consideration can take the form of cash, other stocks and shares or debt (which is usually related to the loan stock). Stamp duty is paid at the rate of 0.5% of the value of the consideration, rounded up to the nearer £5, on each document to be stamped. The stock transfer form needs to be sent to HMRC for stamping within 30 days of the "effective date" of the transfer, i.e. normally the date the form is signed. A penalty is payable for late stamping: 10% of duty if up to 12 months late (20% of duty if 12 to 24 months late and 30% of duty if over two years' late).

Some transactions qualify for relief that can reduce the amount of SD payable. These include transactions between related companies, company reconstructions and acquisitions, and purchases of shares by charities.

Summary

There are two main types of stamp duty – Stamp Duty Land Tax and stamp duties on shares and other securities. Depending on the value of the land or property being sold, Stamp Duty and Tax payable on these transactions can be significant. Stamp duties on shares and other securities is not as significant, but does affect the cost of investing.

Self Test Questions

- What Stamp Duty Land Tax is payable on a property sold for £3,010,000 including £10,000 for carpets and curtains? And does the SDLT change depending on whether the purchaser is an individual or a company owned by that same individual?
- What is the rate of Stamp Duty on share transfers valued at more than £1,000?
- Distinguish between Stamp Duty and Stamp Duty Reserve Tax.

INTRODUCTION

Value Added Tax (VAT) is charged on most goods and services provided in the UK.VAT can only be charged if a business is registered for VAT. There are three rates of VAT depending on the goods and services provided, these are:

- standard rate of 20%
- reduced rate of 5%
- zero rate.

There are also some goods and services that are exempt from VAT.

6.1 THE VAT SYSTEM

UK VAT-registered businesses must add VAT to the price they charge when they provide goods and services to both business customers and consumers, i.e. members of the public, if they are making "taxable supplies". Some supplies are exempt from VAT and these are known as exempt supplies.

A VAT-registered business may also off-set the VAT they pay when they buy goods and services (input tax) from the VAT that they charge on the goods and services they supply (output tax).VAT-registered businesses submit a VAT return showing their output tax and input tax at regular intervals, usually quarterly, and send the difference between the two with the return to HMRC. Where the input tax exceeds the output tax the business may claim the difference back from HMRC.

A business must register for VAT if either its turnover for the previous 12 months has exceeded the VAT threshold (set at £85,000 in April 2017), or it thinks that its turnover will soon exceed this threshold. It is also possible for a business to choose to register for VAT even though its turnover does not exceed the threshold. (Different thresholds apply for distance selling into the UK and for reporting sales to Europe, but these, and associated rules, are outside the scope of this course.)

You can only register for VAT, however, if you are a business. HMRC defines a business as a continuing activity involving getting paid from providing goods or services – in money or another form of payment such as in-kind or barter.

6.2 VAT RATES

All supplies are taxable at the standard rate of VAT unless they are specifically charged at a reduced rate or zero-rated. It is the trader's responsibility to know the appropriate VAT rate to apply. Gov.uk's website provides a list of many dozens of business activities showing whether they are rated (0%, 5% or 20%), exempt or outside scope of VAT. Examples of different supplies are considered in subsequent sub-sections.

6.2.1 Exempt Goods and Services

Where a business supplies exempt goods and services they do not charge VAT on them and they normally cannot claim back the VAT on related purchases. Exempt goods and services include:

- insurance, finance and credit
- health, physical education and sports activities, education and training, burial or cremation services
- admission charges to museums, charities and zoos
- postage stamps and postal services
- selling, leasing and letting of commercial land and buildings – but this exemption can be waived
- betting, bingo and lottery tickets and games (these are subject to other duties).

Where a business sells some goods that are exempt and some that are taxable for VAT, they are "partly exempt" and will be able to reclaim VAT related to the VAT taxable goods and services sold.

6.2.2 Outside the Scope of VAT

Goods and services that are outside the scope of VAT include:

- anything sold (or otherwise supplied) when a business is not registered for VAT and does not need to be registered
- anything bought or sold outside the European Union (EU)
- anything sold (or otherwise supplied) but not as part of a business – e.g. income from sources such as leisure activities or hobbies
- anything bought and sold for personal use, such as a hobby
- donations to charity freely given by a business where the giver does not receive anything in return
- statutory fees and services, e.g. MOT testing, congestion charge
- tolls for bridges, tunnels and roads operated by public authorities
- low cost welfare services provided by charities.

6.2.3 Zero-rated Supplies

If a business makes zero-rated supplies it does not add VAT to the selling price but can still reclaim input tax on purchases and expenses. It is obligatory to record zero-rated goods, showing the 0% rate, on the VAT Return. Zero-rated supplies include:

- food and drink, but not alcoholic drinks, confectionery, crisps and savoury snacks, hot food, sports drinks, food for catering or hot takeaways, ice cream, soft drinks and mineral water
- domestic supplies of water and sewerage
- building services and equipment for the disabled
- equipment for blind and partially sighted people
- prescriptions dispensed by a registered pharmacist
- sale of new residential buildings, buildings for charities, and renovations to a building that has not been lived in for 10 years or more
- supplies of services by contractors when constructing new residential buildings or buildings for charities
- public transport
- books and most other hardcopy publications
- sales from charity shops
- clothing and footwear for children
- cycle helmets, motorcycle helmets and protective boots and helmets for industrial use
- export of goods outside the EU.

6.2.4 Reduced Rated Supplies

The reduced rate of VAT applies to:

- energy saving materials permanently installed in residential or charity premises (but not institutions, e.g. hospitals)
- mobility aids for the elderly
- nicotine patches and gum
- electricity, gas, heating oil, solid fuel, heating including central heating equipment for domestic use or for non-business use by a charity
- children's care seats and safety seats, and carrycots with restraint straps
- sanitary protection products and maternity pads
- renovation or altering an empty residential building and converting premises into different living accommodation.

6.3 SPECIAL SCHEMES

There are some special schemes which are designed to reduce the administrative burden and/or liability for traders. Two of these are considered below.

6.3.1 Flat Rate Scheme

Where a business has an annual taxable turnover of less than £150,000 (excluding VAT), it can simplify its VAT accounting by calculating VAT payments as a percentage of its total turnover including VAT, with a 1% discount in the rate for the first year of VAT registration. The so-called "flat rate turnover" basis can be selected based on cash, supplies or daily takings to suit the retailer's business. The flat rate applied depends on the sector, the type of business it is and, from 4 January 2011, ranges from 4% for businesses retailing food, confectionary, tobacco, newspapers or children's clothing to 14.5% for professional businesses such as lawyers, architects and accountants, and labour-only building or construction services. If a business fits into more than one sector, it will need to decide which sector makes the biggest contribution to turnover: it is not possible to split the turnover and apply different rates; a business can switch to a different sector if trading circumstances so justify on the anniversary of its joining the Flat Rate scheme.

Although the business will still be charged on goods and services provided by the business, it does not have to record the VAT on every sale and purchase. Once joined, a business can stay in the scheme until its total business turnover is more than £230,000.

Where a business chooses to use this scheme it cannot reclaim input VAT, i.e. VAT on its purchases. Therefore, this may not be suitable for businesses which regularly have refunds of VAT. But it may be able to claim back the VAT on capital goods worth more than £2,000 bought in a single purchase. A similar exception provision is available to deal with bad debts.

6.3.2 Margin Schemes

Under a margin scheme a business only accounts for VAT on the difference between the price paid for the eligible goods and the price at which it was sold; VAT is payable at 16.67% (one-sixth) on this difference.

Eligible goods include:

- second-hand goods – goods that can still be used or which could be used after repair
- works of art
- antiques
- collectors' items.

However the margin scheme cannot be used for:

- any item on which you were charged VAT
- precious metals
- precious stones
- gold bought and sold as an investment

Businesses using the margin scheme must still retain record of sales and purchase, .including copy invoices and a stock book tracking each item sold under the margin scheme. Where a business uses a margin scheme, it can still use standard VAT accounting for other items it sells. It can also reclaim VAT on business expenses such as overheads.

Summary

Value Added Tax (VAT) is a tax that is charged on most goods and services provided in the UK. There are three rates of VAT depending on the goods and services provided. There are also some goods and services that are exempt from VAT.

Self Test Questions

- What is the VAT registration threshold?
- What rate of VAT is payable on cremation fees (if any)? What rate of VAT is payable on domestic electricity supply? What rate of VAT is payable on prescription charges?
- What effect can VAT have on the cash-flow of a business making zero-rated supplies?
- Describe the VAT flat rate scheme.

INTRODUCTION

Until the 1965 Finance Act was introduced, corporations paid Income Tax as did every other taxpayer. But just as higher earnings individuals could be expected to pay higher rate tax, or surtax as it was then called, companies needed to pay a profits tax the shape and amount of which was manipulated by successive Governments particularly after the Second World War to try to foster significant reinvestment into the post-war UK economy.

Today, Corporation Tax is paid on the taxable profits of limited companies and of some organisations including clubs, societies, associations, co-operatives, charities and other unincorporated bodies. Each corporation will have chosen its own accounting period which is normally a twelve-month period except perhaps when the company starts in business or modifies its structure or accounting methods. For Corporation Tax, the tax year or financial year runs from 1 April to 31 March.

Two rates of Corporation Tax applied up to 31 March 2015. At April 2015 a unified rate of 20% applied up to April 2017.

Companies or organisations based in the UK pay Corporation Tax on all taxable profits wherever in the world they come from. Non-UK based companies or organisations only pay Corporation Tax on taxable profits arising from UK activities.

7.1 CORPORATION TAX RATES

The rate of Corporation Tax is 19% for 2019/20.

The rate is set at 19% for the financial years beginning 1 April 2018 and 1 April 2019. The Corporation Tax main rate will be reduced by a further 2% to 17% for the financial year beginning 1 April 2020. A previously-planned cut to 18% by 2020 was overtaken by a policy statement in March 2016 and the 2017 March Statement (by the Tory Government) affirmed that a 17% Corporation Tax rate remained the target by 2020. (The Labour Party does not share this aim however preferring a higher rate)

These measures support the Government's objective of a more competitive Corporation Tax system to provide the right conditions for business investment and growth. It also provides certainty for businesses for the expected remainder of this Parliament (before the snap 2017 Election returned a minority Government and the Brexit vote introduced some uncertainties).

Significant reductions have occurred in the levels of Corporation Tax in recent years and the levels of complexity. The drivers for this have been the 1997 Tax Law Rewrite Project which aimed at simplification where possible of the UK tax system and the Government's Corporate Tax Roadmap published in 2010 and which aimed to make UK companies more competitive. Given that the main rate of Corporation Tax was 28% in 2010, this seems to have been successful. From April 2015 the new 20% was the joint lowest Corporation Tax in the G20 countries. Other steps were taken at the same time to apply a tax rate of just 10% to profits coming from the development of patents, providing greater support for research and development and providing further reliefs for high-tech and creative industries.

The two rates of pre-April 2015 Corporation Tax rates were:

- the lower rate – known as the "small profits" rate
- the upper rate – known as the "full" rate or "main" rate.

There was also a sliding scale between the lower and upper rates known as "marginal relief ".

The lower rate, or small profits rate, for Corporation Tax was set at 20% for 2014, unchanged from 2013/14 as the Government moved towards their unified rate from 1 April 2015. This small profits rate could be claimed by qualifying companies with profits which do not exceed £300,000 (regardless of turnover). The upper rate, or main rate, for Corporation Tax was set at 21% for 2014/15 (reduced from 23%). This applied when profits exceeded £1,500,000 or where there was no claim to another rate or where another rate did not apply (as for example to the oil and gas industry).

Marginal relief provided a sliding scale rate of Corporation Tax for companies whose profits fell between the profit thresholds for the two rates, i.e. between £300,000 and £1,500,000. The standard fraction used for marginal relief in 2014/15 was 1/400.

Rates for financial years starting on 1 April Rate	2011	2012	2013	2014
Small profits rate	20%	20%	20%	20%
Small profits rate can be claimed by qualifying companies with profits at a rate not exceeding	£300,000	£300,000	£300,000	£300,000
Marginal Relief Lower Limit	£300,000	£300,000	£300,000	£300,000
Marginal Relief Upper Limit	£1,500,000	£1,500,000	£1,500,000	£1,500,000
Standard fraction	3/200	1/100	3/400	1/400
Main rate of Corporation Tax	26%	24%	23%	21%

Marginal rate is no longer applicable(*) from 1 April 2015 when the small profits rate and main rate became unified at 20%.

(*an exception applies for companies with ring-fenced profits where differential rates and marginal relief can still apply, but this exception is outside the scope of this course.)

To calculate marginal relief the organisation needed to calculate its taxable total profits (N) and, where applicable, its augmented profits (A) Augmented profits are taxable total profits plus any franked investment income, where franked investment income is defined in CTA10/S1126 as any distribution received by a UK resident company that has a tax credit attached to it. Corporation Tax, payable at the main rate is then calculated on the taxable total profits. It was then possible to calculate the profits on which relief is allowable as follows:

$$(U - A) \times N/A$$

where U is the upper limit for marginal relief (i.e. £1,500,000 in 2014/15).

The amount of relief was then found by multiplying the profits on which relief is allowable by the standard fraction.

Example

A company has taxable profits of £1,150,000 and no franked investment income in the accounting period 1 April 2014 to 31 March 2015. The main rate of Corporation Tax in 2014/15 is 21% and the standard fraction is 1/400.

Taxable profits	£1,150,000
Corporation Tax due at main rate of 21%	£241,500
Profits on which marginal relief allowable	£1,500,000 – £1,150,000 = £350,000
Multiply by standard fraction to calculate relief	£350,000 x 1/400 = £875
Deduct relief from Corporation Tax due	£241,500 – £875 = £240,625

If a company's accounting period covers more than one Corporation Tax year work out how many days each rate applied, then work out the tax due for each.

Example

Accounting period is 1 March 2012 to 28 February 2013:

- the rate for the financial year starting 1 April 2011 for 31 days (1 March to 31 March)
- the rate for the financial year starting 1 April 2012 for 334 days (from 1 April to 28 February)

The costs of running the business, which include raw materials, salaries, NICs, business rates and premises costs, can be deducted from profits before the net profits are taxed. Capital costs, which include equipment, plant and machinery and business vehicles, may be set off against pre-tax profits through Capital Allowances, which can be Writing Down Allowances, First Year Allowances or Annual Investment Allowances.

7.2 PAYING CORPORATION TAX AND ASSOCIATED REQUIREMENTS

It is up to organisations to calculate the Corporation Tax they are due to pay in each financial year. Organisations are required to tell HMRC that they are liable for Corporation Tax, pay the correct amount of tax on time and electronically, and file a Company Tax Return and supporting documents online and in a particular format. There are different deadlines for each of these requirements and if those deadlines are not met penalties and/or interest may be charged.

Generally an organisation must:

- pay the Corporation Tax due by 9 months and 1 day after the end of its accounting period
- file its Company Tax Return by 12 months after the end of its accounting period
- file statutory accounts, or abbreviated accounts if it is a smaller (see definition below) company, with Companies House 9 months after the end of its accounting period

Where an organisation has annual profits of more than £1,500,000 for its accounting period, it must normally pay Corporation Tax electronically in instalments. The dates for the instalment payments and the number of payments will depend on the length of the accounting period. For accounting periods of 12 months Corporation Tax will normally be paid in four quarterly instalments, as follows:

- six months and 13 days after the first day of the accounting period
- three months after the first instalment
- three months after the second instalment (14 days after the last day of the accounting period)
- three months and 14 days after the last day of the accounting period.

If an organisation's accounting period is shorter than 12 months, the last instalment will be due three months and 14 days after the last day of its accounting period. If the accounting period is longer than three months, the first payment is due six months and 13 days after the first day of the accounting period. If the accounting period is long enough, other payments will be due at three-monthly intervals.

Penalties for late payment of Corporation Tax:

Time after the deadline	Penalty (for private limited companies)
Up to 1 day	£100
1 day to 3 months	another £100
6 months	10% of bill estimated by HMRC
12 months	Another 10% of bill estimated by HMRC

If your tax return is late three times in a row, the £100 penalties are increased to £500 each.

Penalties for late filing
Penalties arise if accounts are not filed with Companies House or if the tax return is not sent to HMRC by the deadline.
Fines ranging from £100 to £5,000 can arise. Also the company can be struck off the register if accounts or annual return are not sent to Companies House.

Summary

Corporation Tax is paid on the taxable profits of limited companies and of some organisations including clubs, societies, associations, co-operatives, charities and other unincorporated bodies. Up to 31 March 2015, there were two rates of Corporation Tax: the lower rate – known as the "small profits" rate and the upper rate – known as the "full" rate or "main" rate. There was also a sliding scale between the lower and upper rates known as "marginal relief". Note however that the two rates were unified as at 1 April 2015.

Self-Test Questions

- What were the two rates of Corporation Tax?
- How did marginal relief work?
- When did the unified rate commence?
- What are the payment dates for Corporation Tax?

In this Part we consider the environment in which investment products are developed, used and regulated.The Part is divided into Chapters which provide the overall context as well as a survey of the types of assets and investment products.

The first Chapter covers the macro environment.

The following two Chapters consider asset classes and investment products.We consider the types of investment available, their features and uses. As different asset types react differently to changing market conditions, the volatility of returns can be reduced by investing in a diverse portfolio of asset types: investment gains in one asset class can offset investment losses in another.

INTRODUCTION

Against the backcloth of the UK and World economies, investors need to be aware of political developments because of the impact that they can have on the money markets and investments. Domestic politics influence interest rates and how investment markets are governed and taxed, while political changes will be introduced arising from a combination of domestic needs (e.g. putting in safeguards to protect savers after the banking crisis that began in 2008) and international pressures. The Brexit vote clearly underlines the potential impact domestic politics can have on trade as well as money markets and investments.

In the financial markets it is also important to be aware of the policies of central bankers, such as the Bank of England in the UK and the Federal Reserve in the United States. Over recent years Governments have increasingly handed power over to the central banks by making them more independent (and to mitigate possible accusations that political parties are influencing economic factors for party political ends). This can be seen in the UK by the Bank of England's use of interest rates to influence inflation figures.

The credit crisis, however, has seen Governments getting more involved in finance, as can be seen by the bank rescues. Also, as interest rates have reduced to near zero levels, the central banks have had less control over inflation rates. This has seen Governments and central banks working together to find solutions to the problems facing the markets, for example by extending the central banks remit through Quantitative Easing (QE) - and we as yet await the full impacts of the unwinding of QE.

Different policies and ideas on climate change and socially responsible investment (students may see references to ESG investing which considers Environmental, Social and Governance aspects) will also affect markets, particularly specific sectors or individual shares which may gain or lose as a result of the changing backcloth.

1.1 INTEREST RATES AND CURRENCY

Interest represents payment made for the use of someone else's money. Once money is deposited in an interest bearing bank account (or with another deposit taker) the bank pays the investor for the use of the funds in the form of interest. This is funded by the bank lending money to individuals and companies who are charged interest by the bank on these loans.

There can be different rates of interest in operation at any one time and the particular rate of interest paid to a depositor or a lender will primarily depend on the time factor and risk element, often on terms agreed at the time the deposit or loan is made. In general:

- money deposited long term or with specific notice periods attracts higher rates of interest than instant access accounts
- a lower rate of interest will be gained from risk-free investments, such as Gilts, than from more risky corporate bonds (though with Gilts and corporate bonds the overall return is more complex than the nominal interest payable as the market value of the capital invested will fluctuate against the political and macro-economic background)
- the more risk that an investor is prepared to take, the higher the potential return.

Political developments can have an important effect on interest rates and the value of currencies. This can be seen in the remit given to the Bank of England to keep inflation in the UK at around 2%. In an attempt to achieve this, the Bank of England has historically adjusted interest rates viz the Official Bank Rate.

The financial crisis which began in 2008, however, saw the Bank of England reducing interest rates to 0.5% on 5 March 2009.This left it with few options for influencing inflation, though there was a reduction to 0.25% in August 2016 to "boost the economy", accompanied by limited QE. This reduction was reversed in November 2017 when the rate was reset to 0.5% the first rise since 2007 with the Governor of the Bank of England stating that the rise was to dampen Brexit-fuelled inflation. But, back in 2009, the UK Government gave the Bank a remit to inject money directly into the economy through QE. The combination of low interest rates and QE was intended to provide the economy with a boost and reduce the risk of inflation falling below the Bank's target of 2%. Between March 2009 and January 2010, the Bank purchased £200 billion of assets, mostly medium and long-dated Gilts. The Government also authorised the Bank to pursue a number of activities targeted to improve the functioning of specific financial markets. This included purchases of high-quality commercial paper and corporate bonds. The scale of these operations was much less than for the Gilt purchases. Combined the operations totalled £375 billion.

In other countries, QE has also been used, notably in the United States where announcements from the Chairman of the Federal Reserve have been closely monitored. World stock markets often reacted quite violently, during 2013 and 2014, to suggestions that the States would cut back, or would not cut back, on its QE programme. In October 2014, the then Chair of the US Federal Reserve's Board of Governors, Janet Yellen, announced that the final purchase of bonds would be made, calling time on its radical six-year $4.5tn bond-buying QE programme designed to help the world's largest economy through the financial crisis. This was supplemented by Janet Yellen's December 2015 announcement that the benchmark federal-funds rate, the overnight interbank lending rate, would be raised from near zero to between 0.25% and 0.5% and would be adjusted further depending on how the economy performs. At 0.5% for almost the whole 2016, successive increases are being predicted for the Trump Presidency, above the June 2017 level of 1.25%.

Japan too, for two decades the comfortable home of low interest rates, of tightly controlled money supply and of deflation, has embarked on its own QE which has seen significant and sustained positive sentiment return to the Japanese stock market for the first time in those two decades.

Other countries have also seen significant reductions in interest rates, notably in Europe in from 2014. The European Central Bank in June 2014 pushed overnight lending from the ECB to national banks to a low of 0.15% while the banks overnight deposit facility rate, which was 0.25% below the lending rate fell into negative territory at minus 0.10%.
[Source: https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html]
At the end of 2011, the overnight lending rate was 1.00%; by March 2016 it had fallen to 0.00% (even lower than above-mentioned 0.15%) with the deposit facility rate standing at minus 0.40%. The ECB's intention in this is to maintain price stability and foster economic growth. Lower interest rates in the EU have been accompanied by significant Quantitative Easing, preceded by the ECB's purchase of a limited amount of *inter alia* mortgage-backed bonds in 2014 and purchased sovereign debt during 2010/12 to bolster the ailing Greek, Spanish and Italian economies in particular. From March 2015 purchases of €60 billion of mainly public debt have been made almost every month, totaling about €2 trillion by 2018.

Exchange Rates
Trade between countries usually involves the use of different currencies. The foreign exchange markets allow for the currency used in one country to be purchased with the currency of another country. UK exports create a demand for sterling by foreign buyers while UK imports create a domestic demand for foreign currencies with which to pay for the imports.

An exchange rate is the price at which two currencies trade. Exchange rates can be fixed to another at rates set by the Government or there can be a floating exchange rate regime where currency exchange rates are based on the supply and demand for currencies. In the UK, the exchange rate has floated since September 1992, when Britain left the European Exchange Rate Mechanism.

Real exchange rates are the effective exchange rates between countries, adjusted to take account of differences in their rates of inflation and other countries' view of that currency. This is a good indicator of a country's competitiveness. If the real exchange rate rises, domestic goods become more expensive relative to foreign goods and can have a negative effect on domestic production. If the real exchange rate falls, however, then domestic goods become relatively cheaper and so demand for them increases.

The value of the currency is partially determined by the health of the national economy, especially the Balance of Payments current account (see section 1.6 for more details). A surplus in the current account results where a country exports more goods and services than it imports and therefore buyers have to acquire the currency to pay for the goods. This adds to a country's foreign reserves and strengthens the currency. The reverse is true where there is a current account deficit.

A strong currency can have beneficial effects, such as reducing the cost of imported goods. If the currency becomes too strong, however, it can add pressures to the domestic economy by making exports more expensive and thus weakening the country's competitive position. To appreciate the significance of a strong or a weak currency, consider the position of China over the last decade. As China has emerged as an economic superpower its weak currency has been revalued, in particular to the relief of a United States worried about its own balance of trade deficit, to make its goods less competitive. More recently, worries about the slowdown in Chinese economic growth rate intermittently trouble world stock markets.

1.2 INFLATION

One of the key economic factors affecting everyone is inflation and this is a key consideration for investors. Rising prices reduce the real return from investment, not only in the original value of the investment but also in future returns and dividend payments. Inflation rates are likely to have a greater impact on those with a fixed income, than those in employment. This is because as prices rise the purchasing power of an individual on a fixed income is eroded in real terms, whereas, historically, rises in national average earnings have been higher than price inflation.

1.2.1 Measuring Inflation

There are a number of different measures of inflation. They reflect changes in the general level of prices charged for goods and services and give indications of changes in the cost of living. In the UK, there are two main measures of inflation, the retail prices index (RPI) and the consumer prices index (CPI). The measures differ in the range of consumer purchases they include. From December 2003 the Chancellor of the Exchequer changed the main measure of inflation from the RPI to the CPI

Retail Prices Index

The Retail Prices Index (RPI) measures changes in the total cost of a selection of goods and services in the UK. The contents of the RPI are chosen by the Office for National Statistics (ONS) to reflect their relative importance in a typical household budget.

The ONS also publishes a number of derivatives of the all-items RPI. The RPI-X excludes mortgage interest payments while the RPI-Y excludes both mortgage costs and the impact of changes in direct taxation, such as VAT, excise duties and other specific taxes. It is a measure of underlying price change excluding the direct impacts of economic policy changes.

Consumer Prices Index

The Consumer Prices Index (CPI) is an internationally comparable measure of inflation, as it is calculated on the basis of a number of European regulations. The measure was published in the UK until December 2003 as the Harmonised Index of Consumer Prices. It differs from the RPI in terms of the number of items included in the index, the types of households included in the survey and the calculation methods adopted.

The CPI forms the basis for the Bank of England's inflation target, a role the Bank was given in 1997.The role was confirmed the following year when the Bank of England Act granted its independence from the Government – and importantly independence from political influences. Currently the inflation target is set at an annual rate of 2% (CPI) and this has been the target since December 2003 (prior to that the target was at an equivalent 2.5% RPI-X). In December 2014 the UK's inflation rate fell to 2%, the first time inflation had been at or below the target of 2% for six years. 2015 and 2016 have seen continued low rates of inflation, though the fall in the value of Sterling following Brexit reintroduced inflationary trends.

1.22 Disinflation

Disinflation occurs when there is a decrease in the rate of inflation, i.e. the prices of goods and services are still rising but at a slower rate. Typically this can happen during a recession, as sales drop, and as retailers are not able to pass on higher prices to customers.

1.23 Deflation

Deflation is a general decline in prices, often caused by a reduction in the supply of money or credit. Also, it can be caused by a decrease in Government, personal or investment spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression. Central banks attempt to stop severe deflation, along with severe inflation, in an attempt to keep the excessive drop in prices to a minimum.

Declining prices, if they persist, generally create a vicious spiral of negatives such as falling profits, closing factories, shrinking employment and incomes, and increasing defaults on loans by companies and individuals. To counter deflation, monetary policies can be used to increase the money supply and deliberately induce rising prices, causing inflation. Rising prices provide an essential lubricant for any sustained recovery because businesses increase profits and this takes some of the depressive pressures off wages and debtors of every kind.

Deflationary periods can be either short or long, relatively speaking. Japan, for example, had a period of deflation lasting decades starting in the early 1990s.The Japanese Government lowered interest rates to try and stimulate their economy, to no avail.The zero interest rate policy was ended in July 2006 and as indicated above Japan has more recently been trying Quantitative Easing to stimulate their economy. As part of this new policy, the Bank of Japan announced in April 2013 its intention to buy ¥7tn yen (£46bn) of Government bonds each month using electronically created money, with the aim of rekindling demand and pushing up prices and wages. The Bank of Japan's governor described its stance as "monetary easing in an entirely new dimension", promising to target a doubling in the size of the "monetary base" – the amount of cash circulating in the economy, plus the reserves held by financial institutions at the central bank – in the hope of stoking inflation of 2% within two years.This more aggressive approach to tackling Japan's economic problems had been well-trailed, but the scale of the Bank of Japan's operation still surprised financial markets, pushing the Nikkei 225 index of leading shares from 12,000 in early April 2013 to over 15,600 just six weeks later. In the last half of 2012 the Nikkei had hovered around the 9,000 level. By Autumn 2017 the Nikkei 225 was trading at over 21,000. Japanese CPI rates were also significantly increased averaging 2.76% during 2014 and 0.80% in 2015.

[Source: http://www.inflation.eu/inflation-rates/japan/historic-inflation/cpi-inflation-japan.aspx]

1.3 ECONOMIC CYCLES

The "economic cycle" (or business cycle) is the natural fluctuation of the economy between periods of expansion, or growth, and periods of contraction, or recession. When determining the current stage of an economic cycle, factors such as Gross Domestic Product (GDP), interest rates, levels of employment and consumer spending should all be taken into account. When the GDP falls compared with the previous quarter the economy is said to be contracting, but when it rises compared with the previous quarter the economy is said to be expanding.

There are four main stages to an economic cycle (investment professionals will often identify these, and variants thereof, in assessing investment policy and making their investment decisions):

1.3.1 Economic Boom

A boom occurs when national output is rising strongly. This is likely to be at a rate which is faster than the trend rate of growth (or long-term growth rate) of about 2.5% per year. In these conditions, output and employment will both be expanding and the level of demand for goods and services is likely to be very high. Typically, businesses will use this opportunity to raise output and to widen their profit margins. The characteristics of an economic boom include:

- strong and rising level of aggregate demand
- rising employment and real wages
- high demand for imported goods and services
- Government tax revenues will be rising quickly
- company profits and investment increase
- increased utilisation of existing resources.

As prices and inflation continue to rise there is a danger that the economy will overheat, in which case interest rates will be increased by the Bank of England to dampen demand.

1.3.2 Economic Slowdown

A slowdown occurs when national output is still rising but the rate of growth slows. If the economy can continue to grow at a slower rate without falling into recession, this is known as a "soft-landing".

The Bank of England has tried to engineer a soft-landing for Britain on at least two occasions since it was given independence by increasing interest rates in an attempt to reduce demand, e.g. between the summer of 1997 and spring 1998 interest rates rose from 6% to 7.5%.

1.3.3 Economic Recession

A recession is when there is a fall in the level of real national output (i.e. when the rate of economic growth is negative). As national output declines, this leads to a contraction in employment, incomes and profits. When the GDP contracts in two successive quarters the economy is said to be in a recession. The economy will eventually reach its trough.

An economic slump is a prolonged recession which can lead to a significant fall in output and average living standards.

The characteristics of an economic recession include:

- declining aggregate demand for output
- contracting employment / rising unemployment
- a sharp fall in business confidence and profits and a decrease in capital investment spending
- de-stocking and heavy price discounting

- reduced inflationary pressure and falling demand for imports
- increased Government borrowing
- lower interest rates from central bank.

1.3.4 Economic Recovery

A recovery occurs when national output picks up from the low point of the recession. The pace of recovery depends in part on:

- how quickly demand starts to rise after the economic downturn, and
- the extent to which producers raise output and rebuild their stock levels in anticipation of a rise in demand.

In the UK economic cycles are often affected by elections. Governments may use economic policies to create favourable economic conditions when a vote is taking place, e.g. tax cuts. The Government will then look to rein in the economy immediately an election has taken place.

Although political influence on economic cycles had been reduced by handing over the power to set interest rates to central banks, the recent financial crisis has increased political influence in this area as central banks and Governments work together to set economic targets.

1.4 GLOBALISATION

According to the International Monetary Fund (IMF), globalisation is "the process through which an increasingly free flow of ideas, people, goods, services and capital leads to the integration of economies and societies".

Globalisation is not a recent phenomenon: it is easy to trace it back to the UK's Industrial Revolution and the European empire builders of the 1800s. Before then, the seventeenth century "Mercantilist" Chancellors in Europe used military might to control what they thought was a fixed amount of global wealth. Further examples of "globalisation", of necessity more limited than today but at the time they were dealing with the known world and the principle is the same, are evident in Roman, Viking and Inca history to name but a few: localised perhaps but the concept of trade was important then. The current wave of globalisation, which arguably started after the end of World War 2, has seen a large number of countries adopting more open economic policies. This has resulted in increased international trade in goods and services, and cross-border flows of both capital and labour. In addition to this, developments in information and communications technology have lowered transport and communications costs, which in turn have increased the tradability of goods and services.

International trade has created opportunities for emerging economies to sell their produce across the world. As emerging economies have increased their share of the global market, many developed economies have seen a fall in their share of the global market (echoing the fears of "Mercantilist" Chancellors perhaps?) for manufactured goods, but an increase in their share of the service sector, particularly in the financial services sector and the provision of professional business services. From time to time, countries baulk against the trend of more open economic policies: we are currently witnessing strong hints of protectionism in the United States as Donald Trump promises to put America first and place tariffs on imports to reduce the United States' trade deficit. Brexit too has witnessed EU threats to impose tariffs on trade with the UK. While protectionism is the opposite of the IMF's concept of globalisation, it is an indicator of how significant globalisation has become.

Whichever way the economic cake has been sliced and whatever its effect on individual countries, Globalisation has created opportunities for business through opening up new markets, and providing access to new technologies and cheaper products for consumers. It also creates challenges. It has put UK firms and workers in competition with those from across the globe and reinforces the need for UK firms to continue to innovate and

offer higher quality goods and services: it is clear that major UK industries, for example textiles of the nineteenth and twentieth century and to a lesser extent motor manufacturing of the twentieth, have lost out to the Indian sub-continent, Indonesia, South Korea and China to name but a few winners in this contest.

As a result of operating across the globe, financial markets can be affected by international political developments. Events, such as unrest in the Middle East, can directly affect the price of commodities, such as oil, and this in turn can influence the price of shares in companies dealing either directly or indirectly in these markets.

Therefore, although Globalisation has made it easier for investors to invest in foreign markets or in the shares of multinational companies with large overseas operations, they must be aware of international developments when allocating assets.

1.5 FISCAL AND MONETARY POLICY

1.5.1 Fiscal Policy

Fiscal policy involves using Government spending, borrowing and taxation to influence both economic activity and the level of aggregate demand, output and employment.

Changes in Government spending, taxation and the budget balance can be used to help smooth out some of the volatility of real national output (i.e. GDP). For example, between 2001 and 2005 there was a fiscal stimulus to the UK economy through substantial increases in Government spending on transport, health and education.

Public sector current expenditure each year (£679bn for 2015/16 per HM Treasury Public Spending Statistics July 2016 (Revised), Table 1.1) takes up 40.1% of Gross Domestic Product and can be broken down into three main areas:

- *Transfer Payments*: i.e. welfare payments made through the social security system. Their main aim is to provide a minimum standard of living for low income households.
- *Current Government Spending*: i.e. spending on State-provided goods and services that are provided on a recurrent basis every week, month and year, for example salaries paid to civil servants and resources used in providing state education, NHS services and defence.
- *Capital Spending*: this includes infrastructural spending such as on new motorways and roads, hospitals, schools and prisons. This adds to the economy's capital stock and can have important demand and supply side effects in the medium to long term.

Taxation is the main source of revenue for the Government. Although there are many different types of taxation as considered in Part 2 of this study manual, in general they fall into one of two categories, direct taxation and indirect taxation. Direct taxation is levied on income, wealth and profit and includes Income Tax, National Insurance Contributions, Capital Gains Tax, Inheritance Tax and Corporation Tax. Indirect taxes are levied on spending and include excise duties on fuel, cigarettes and alcohol and Value Added Tax on many different goods and services.

In a recession or at times of low economic activity, the Government may increase its spending or cut taxation to stimulate demand in the economy. Conversely, in a boom the Government may reduce spending or increase taxation to dampen demand.

The decisions made by investors may be influenced if different tax treatments are applied to various types of products. Also, tax policies affecting company earnings may affect dividend policies, where and how a company invests and how a company chooses to raise capital.

1.5.2 Monetary Policy

Monetary policy attempts to stabilise the economy by controlling interest rates and the supply of money. Since May 1997, the Monetary Policy Committee of the Bank of England has been responsible for setting interest rates in the UK. Also, since 2009, the remit of the Bank of England has been extended to allow it to increase the supply of money into the economy through QE. QE has helped to prevent a fall in demand for goods and services thereby introducing a stabilising factor into the economy.

Monetary policy works by changing the rate of growth of demand for money. Changes in short term interest rates are used to affect the spending and savings behaviour of individuals and businesses. There is a time lag between making changes and a policy becoming effective. Because of the time lag involved, the Bank of England sets short term interest rates on the basis of hitting the inflation target over a two-year forecast horizon.

By reducing short term interest rates, the Bank of England eases monetary policy. If the financial markets agree with the Bank's view of the prospects for inflation, longer term rates should reduce. This will lead to rising asset prices and this increase in wealth, together with lower interest rates, will make people more willing to borrow and spend. This in turn will increase expenditure and stimulate demand and employment. People dependent on income from cash deposits, however, will be worse off.

By increasing short term interest rates, the Bank of England tightens monetary policy. This should raise long term interest rates and lead to a fall in asset prices. This will make people less willing to borrow and will reduce expenditure and demand and tend to increase unemployment.

1.5.3 Money Supply

Money supply is the amount of money in circulation in the economy and provides an indicator of the strength of consumer demand. The most commonly quoted measures of money supply in the UK have been M0 and M4.

M0, also referred to as "narrow money", consisted of the notes and coins in circulation together with banks' operational deposits with the Bank of England. M0 showed changes in economic cycles, with growth in M0 indicating that consumer spending is buoyant while a contraction suggests that consumers are being more cautious. The Bank of England ceased to publish this data as such in 2006 but data on money and coin in circulation are still made available.

M4 is a broader measure of money supply, consisting of the notes and coins in circulation together with the savings of UK residents in instant access and time deposit accounts with UK banks and building societies. It also includes the deposits created by banks and building societies through their lending activities. An increase in the availability of loans, whether from consumer demand or encouraged or discouraged by banks' lending policy, will be reflected in a faster growth in M4. M4 is regarded as a key statistic which reflects the underlying strength of economic activity. When the UK economy went into recession, M4 growth fell rapidly from 15% a year at the end of 2008 to negative growth 18 months later. During 2011 and 2012 continued negative M4 growth indicated that economic activity was falling and at this time the economy went into a double dip recession. Detailed monthly analysis of M4 is made available by the Bank of England. The Bank of England's monthly Bankstats (Monetary & Financial Statistics) shows (in Table A2.2.1) that M4 has tended to increase from around £2,090bn in September 2015 to around £2,300bn in August 2017.

Where the amount of money in the economy is increased without a corresponding increase in the supply of goods and services that can be bought there will be an excess of consumer demand over supply. This will force up the general level of prices causing inflation. By reducing the money supply this trend can be reversed.

The Bank of England can influence money supply by selling and buying Treasury Bills and Government stock on the open market.

In March 2009, the Bank of England began pumping up to £375 billion in cash into the economy through QE. This was a new policy of creating money to purchase Government Gilts and corporate bonds in an attempt to increase the UK's money supply.The intention was to bring liquidity to the financial markets by increasing the lending capacity of the banks, so that they would lend more money to businesses and individuals. It was hoped that this would lead to an increase in spending that would stimulate the economy. How successful the policy is remains to be seen since an element of money supply is how quickly cash can move around the markets as a result of bank lending. There is evidence that instead of releasing money into the market generally (thereby stimulating the growth in M4 as discussed some two dozen lines earlier), the banks have held onto the money as reserves fearful of a return to the banking crisis of 2008. Further data on QE is provided in section 1.1 above.

1.6 BALANCE OF PAYMENTS

The Balance of Payments for a country is the record of its trading transactions with other countries. It measures the economic transactions between UK residents and the rest of the world. It also draws a series of balances between inward and outward transactions, provides a net flow of transactions between UK residents and the rest of the world and reports how that flow is funded. Economic transactions include:

- exports and imports of goods, such as oil, agricultural products, other raw materials, machinery and transport equipment, computers, white goods and clothing,
- exports and imports of services such as international transport, travel, financial and business services,
- income flows, such as dividends and interest earned by foreigners on investments in the UK and by UK residents investing abroad,
- financial flows, such as direct investment, investment in shares, debt securities, loans and deposits, and
- transfers, which are offsetting entries to any one-sided transactions listed above, such as foreign aid and funds brought by migrants to the UK.

The Balance of Payments can be split into the Current Account and the Capital Account.The Current Account deals with the import and export of goods and services, while the Capital Account deals with foreign investments in the UK, UK overseas investment and loans.Together these accounts provide a complete statement of the UK's trade and financial transactions with the rest of the world. In simple terms, and referring to the UK specifically, a country can run a long-term deficit on its Current Account, which the UK has done each year since 1984 (1982 was the last year which saw a trade in goods surplus, while a surplus in trade in services has since helped to reduce the deficit), but this deficit is of little detriment if balanced by a surplus on the Capital Account.The UK has done this by attracting investment from abroad, notably India and the Far East in recent decades. Nonetheless the recent size of the Current Account deficit (the UK's Current Account deficit was £115.4bn in 2016, equivalent to 5.9% of GDP) is raising questions for some economists (equivalent figures in 2012 were £71.6bn and 4.2%).

Statistics for both the Current Account and the Capital Account are produced in the Office for National Statistics Pink Book, the above data being extracted from Appendix 1.1 to the Pink Book.

1.7 THE ROLE OF FINANCIAL INVESTMENT

Financial investment, in the context of investing capital in infrastructure and in industry producing goods and services, can have a major impact on a country's economic development. In summary, it facilitates and formalises the transfer of funds between Government, individuals and businesses.

It can stimulate demand and improve productivity by investing in the most up-to-date production methods. Investing in industrial plant and machinery, social infrastructure, research and development, and education and training diverts money away from consumption into expenditure that will provide future growth in the economy. Consider the encouragement successive Prime Ministers give on their trade missions for foreign states to invest in the UK (and to buy British goods, the latter being a positive contribution to improving our Balance of Payments). In a market economy, financial institutions and markets, such as banks and stock exchanges, play a central role in moving funds from where they are available to where they can best be used.

Summary

Against the background of World and UK economies, investors need to be aware of political developments because of the impact that they can have on the money markets and investments. Domestic politics will influence interest rates, how investment markets are governed and taxes. However, the effects of globalisation should also be considered. Changes in the financial markets will result from a combination of domestic needs (e.g. putting in safeguards to protect savers after the banking crisis that began in 2008) and international pressures.

Self Test Questions

- What are the main measures of inflation used in the UK?
- Explain fiscal and monetary policies.
- Summarise what is meant by the Balance of Payments.

INTRODUCTION

Individuals, trusts and other organisations have various assets in which they can invest. These investments can be broken down into a number of principal asset classes, including:

- equities (UK and Overseas)
- bonds (fixed interest and index-linked)
- cash
- property, and
- alternative investments.

In this Chapter we will look at the characteristics of these asset classes.

2.1 UK EQUITIES

Within the UK equity market, there are various indices, which measure the fortunes of the stock market. The most commonly referenced indices are the FTSE 100 and the FTSE 250. The FTSE 100 (sometimes referred as the "Footsie") consists of the 100 largest companies quoted on the London Stock Exchange by market capitalisation (total value placed by the stock market price on the shares in issue). These larger stocks are considered less risky investments than the shares of smaller companies ("small caps"), which are generally less well scrutinised by equity analysts, less liquid and, given their size, more susceptible to business failure.

Collectively FTSE 100 stocks represent about 81% of UK market capitalisation, capitalisation being the value of issued shares. The FTSE 250 is an index of medium capitalised companies not included in the FTSE 100, i.e. the 101st to 350th largest companies: these companies represent around 17 per cent of UK market capitalisation. The FTSE 350 combines the FTSE 100 and FTSE 250. As an indicator of the different capitalisation sizes of individual companies, Moss Bros Group, a well-known High Street name, is worth around £96,300,000. It is nowhere near large enough to be included in the FTSE 250 though it is listed on the FTSE Small Cap index. John Laing is one of the smallest stocks included in the FTSE 250 with a capitalisation of £1,250,100,000. Royal Dutch Shell tops the list at £195,805,500,000. (Data published in November 2017.) In addition to the indices mentioned above, which are included in the FTSE All-Share Index and comprise almost 700 companies or 98% of UK market capitalisation, advisers will come across FTSE Fledgling and FTSE AIM in considering UK investments for their clients. The figures were correct at 24 October 2017: they will be different when the student is reading this but being fully aware of the fluctuating value of shares is key to understanding investments. The constituents of indices are reviewed from time to time

Companies can issue different types of shares, such as ordinary shares and preference shares. These give investors different rights, which we consider in the following sections.

2.1.1 Ordinary Shares

Owners of ordinary shares generally have the right to vote in general meetings on various issues affecting the running of the company. Day to day management of the organisation lies with the firm's management team but there are some issues that should be put to the shareholder vote. These include mergers and takeovers, board appointments and raising new share capital.

A company's ordinary shares rank below all other forms of loan capital and share capital in a company's capital structure. In other words, all commitments to holders of debentures, loan stocks and preference shares must be met before ordinary shareholders become entitled to dividends or repayment of capital.

212 Preference Shares

Preference shares have various debt like qualities. For example, preference shares do not usually carry the right to vote at a company's meetings. However, preference share owners can expect a fixed rate dividend payment, which is usually based on a percentage of the nominal value of the share. For example, the holder of a 6% £1 preference share can expect to receive 6p per year. As the name suggests, dividends for preference shareholders are paid before ordinary shareholders (and they are also repaid before ordinary shares in the event of company liquidation). However, as with all dividends, payment is made at the discretion of the company directors. Preference shares are often cumulative; thereby if a dividend is not paid one year it will be rolled over until the next, and so on. If no dividend is paid for a certain period of time, preference shareholders are often subsequently afforded voting rights.

Other features of specific types of preference shares:

- *participating* shares have a right to a proportion of profits if they exceed a certain level;
- those with *conversion* rights can be converted into ordinary shares at specified dates;
- some preference shares have *redemption* dates.

213 Equity Markets

The primary market is the market for new issues of shares and which enables companies to create new capital. This new capital is raised direct from investors, almost invariably large institutions. New share issues usually require the approval of existing shareholders as the new issue would dilute the value of their shareholding.

The secondary market is where investors can buy and sell shares of publicly listed companies already in circulation. This is done on a recognised stock exchange and individual trades are significantly less in value than those on the primary market.

Primary Market

Companies that wish to raise capital by issuing shares in the primary market can issue shares in five ways:

- Offer for Subscription – a company issues shares directly to the public. Instances of this are rare given that most companies do not have the expertise or the resources to carry out such an operation
- Offer for Sale – an issuing house (often a broker) is appointed to manage the process, from advertising the shares to paying the proceeds back to the issuer (minus a fee)
- Placing – a company simply hands its shares to a broker, which then sells them to its clients. If more than one broker is used, this is known as an intermediaries offer
- Introduction – this is not designed to raise money for the issuing company, as in the above methods, but involves bringing the shares already held by shareholders to the market place
- Rights Issue – a company with existing shares in issue may issue new shares to raise capital, giving existing shareholders right of first refusal ("pre-emption rights").

There are two ways in which the price of a share issue can be set: by a fixed price offer or a tender offer.

Under a fixed price offer the issuing house (an investment bank or other financial institution) will establish a price for the stock based on similar shares that are already trading in the marketplace. Offer prices are often artificially low to ensure investor interest, given that an immediate rise in share price can be predicted.

Under a tender offer investors are required to state the price that they are willing to pay and the number of shares that they want to buy. These potential buyers are ranked in order of who is willing to pay the most and apportioned accordingly. The price will usually be set at the point on this list, moving down from the highest price offered, at which the offer is fully subscribed. As in the fixed price offer, the final 'strike' price will usually be below this level to facilitate an immediate uplift to the share price.

The issue process is lengthy and adverse market developments may occur during this period, therefore underwriting is often used. Underwriting is a means of guaranteeing a minimum level of proceeds from a share issue. To protect themselves, the company issuing a share can pay a fee, known as underwriting commission, to financial institutions that are willing to 'underwrite' the issue. These institutions guarantee to take up any shortfall and to pay the agreed price.There is no limit to the number of underwriters who can participate in an underwriting syndicate.

Secondary Market

The London Stock Exchange (LSE) is itself a publicly listed company, which provides a market place for shares to be traded. It is a secondary market, essentially a forum for the buying and selling of second hand shares at prices determined by supply and demand.

As well as running the Main Market for shares in larger companies, the LSE provides a marketplace for trading in the shares of newer and smaller companies, known as the Alternative Investment Market (AIM). There are less stringent regulatory requirements for companies wishing to list on AIM than those listing on the Main Market. The Professional Securities Market also exists to enable companies to raise capital through the listing of specialist securities, including debt and depositary receipts.

The key trading systems used for trading on the LSE are SETS (Stock Exchange Electronic Trading Service) and SEAQ (Stock Exchange Automated Quotations System). Larger, or more liquid, stocks (generally FTSE 100 companies) are traded electronically on SETS, which allows buyers and sellers to trade directly with one another. SEAQ is for more illiquid shares and involves two way prices for market makers and broker dealers.

2.2 OVERSEAS EQUITIES

UK equities make up only around 4.7% of the global stock market by market capitalisation (beginning of 2016) [Source http://www.visualcapitalist.com/all-of-the-worlds-stock-exchanges-by-size/] and so there are many opportunities to invest internationally.

It is worth remembering that a company may choose not to list its shares in the country in which it is headquartered, primarily for the reason that the major stock exchanges (e.g. London, New York,Tokyo) provide the company with access to a larger and wider base of investors. For example, the FTSE 100 index includes stocks from companies in Kazakhstan, Australia, South Africa, Switzerland and India. Shares may also be dual or multiple listed on two or more different exchanges.

Equities in developed countries are usually considered less risky than those in emerging markets and generally display less volatility. Meanwhile, investors should also be aware of the implications of currency fluctuations when investing in overseas equities.

2.3 EQUITY ANALYSIS

In order to assess whether the current share price is reasonable, investment professionals evaluate it against the issuing company's earnings prospects, dividend payments and assets base, often within the context of a particular industry group or a market to which the company belongs.

Investment professionals use a variety of methods to put a value on a share from the information they can readily access. The following methods are among the simplest and most common valuation techniques:

- Return on Invested Capital: Profits divided by the amount of capital (equity and debt) required to generate the profit. A number that is high, and above the return available from a building society, may indicate a successful company which turns out to be a good investment.
- Price to Earnings Ratio: Share price divided by historic or prospective earnings per share. A stock's price to earnings (P/E) ratio will be judged in relation to the ratios of other companies in the same type of business. If the ratio is higher than those of its peers, the stock may be seen as overvalued, or it may be that its growth prospects are thought to be superior. Earnings forecasts are often used in order to value the current share price against anticipated earnings growth.
- Dividend Yield: Dividend per share divided by share price. This shows the return that the annual dividend per share represents in relation to the current share price. The higher the yield, the more attractively valued the stock, assuming that the dividend payment is sustainable.
- Price to Book Ratio: Share price divided by net book value (shareholders' equity) per share. This compares the current share price with the company's break-up value.

2.4 BONDS

Bonds, also referred to as fixed income or fixed interest securities, are a way for Governments and companies to borrow money through the debt market. They are considered a lower risk investment than equities, as they promise to pay a fixed income over the period of the bond and return capital on maturity (unless like the British Government's War Loan stock, they are undated – though the UK Treasury redeemed the outstanding £1.9 billion of First World War debt, 3?% War Loan, on 9 March 2015 to take advantage of lower interest rates. For the same reason, the Treasury redeemed, on 11 February 2015, 4% Consols which were the consolidation of debt dating as far back as the eighteenth century and the last remaining six issues of UK Government undated Gilts had all been redeemed by 5 July 2015). But the investor and his adviser need to remember that the credit standing of the Bond issuer is an important factor. High risk bonds with low ratings accorded by the ratings agencies (this point is considered further below) may well be much more risky than the "blue chip" equities of FTSE 100 companies. Remember too that it is not just companies which are given ratings: sovereign Governments are also assessed by credit rating agencies.

Bonds can offer a steady and predictable income stream, as well as security of capital if held to maturity (or redemption in the case of War Loan and Consols) and provided that there are no defaults by the issuer. Used in a portfolio, bonds can help offset the short term volatility of shares, while still providing income.

Although bonds typically pay out a fixed coupon * (return/interest) over a known period of time and a fixed refund of the principal amount at maturity, the capital value of a bond changes during its lifetime as it is traded by investors. A number of factors affect the capital value or price of a bond:

* the term "coupon" arose from the way bonds used to be issued: the bond certificate was produced with tear off slips, or "coupons", which could be exchanged for the interest due

- actual and expected changes in interest rates: if interest rates (on a deposit/savings account) rise or are expected to rise, the fixed coupons (see Nominal Yield in the first bullet point in next paragraph) offered by bonds look less attractive. The market will then adjust the price of a bond so its yield looks fair compared to the rates of interest on other investments
- actual and expected changes in inflation: inflation can erode the "real" value of the fixed income on bonds. If inflation rises, bonds tend to fall in value to reflect this
- economic outlook: a strong economy tends to lead to higher interest rates and/or higher inflation. It also provides a more favourable backdrop for equities, which can reduce investor demand for bonds, and hence bond prices

- credit environment: corporate bond issuers need to pay investors a higher yield than Government issuers in order to compensate for the additional risks involved as there is a higher probability of a company defaulting on an interest payment or repayment of capital than a Government. (This differential is known as credit spread, an investment risk.) Corporate bond prices will fall if the issuer becomes less likely to be able to repay the capital and vice versa. Market fundamentals, such as corporate earnings and default rates, will also affect the price of a corporate bond. In a favourable credit environment, companies do not need to offer as much reward to investors than during periods when the risk of default is high. As corporate bond yields decline, their prices rise and vice versa
- supply and demand: a mismatch between supply and demand leads to price fluctuations. Future supply depends on Government balances and corporate borrowing needs. Demand has recently been affected by pension schemes' growing needs for longer maturity bonds to match the duration profile of their liabilities and this in turn has tended to increase the price.

The return on a bond investment is typically measured by its yield. Yield can be measured in different ways taking into consideration interest payments during the life of the bond and its maturity/redemption payment. The following yield measures are widely used by bond investors:

- Nominal Yield (also referred to as "coupon"): reflects the overall income generated by a bond as a proportion of its nominal value
- Income or Running Yield: reflects the overall income generated by a bond as a proportion of its current market value
- Redemption Yield (also known as yield to maturity): the income generated combined with the capital loss or gain on the bond, if the bond is held to the maturity date.

Running Yield has an inverse relationship with the price of a bond. When a bond's price rises, its yield falls and when a bond's price falls, its yield rises.

The total return on a bond consists of two components: the income return (the income generated by the bond holding) and the capital return (the gain or loss on the initial investment).

The difference in yields across bonds of different maturities is reflected in the yield curve. Long maturity bonds usually yield more than short maturity bonds, as there is a greater risk of default and greater uncertainty over economic and inflationary developments over the longer time period. A normal yield curve would therefore slope upwards along the maturity axis. However, there are periods in bond markets where the yield curve can invert, with short term yields exceeding long term yields. This can happen when the market anticipates a fall in interest rates in the medium to long term, but still prices in interest rate rises in the short term. Then again the "curve" can be flat – or at least very similar in the short term as in the long term with dips or humps in the middle. Bear in mind that the curve is not necessarily regular and can twist depending on changing political and economic conditions. Yield curves can also be used with other investment media.

2.5 TYPES OF BONDS

Government Bonds – Sterling and Overseas

Government bonds, issued by the central Governments of countries (such as UK Gilts, US Treasuries, German Bund), are traditionally considered the "safest" type of bond, as they are backed by Government guarantees and there is a very low risk of default, except for financially unstable countries. Where there is considered to be a greater risk of default then yields can be expected to be higher, in effect incorporating a credit risk premium, as happened with Portuguese, Irish, Italian, Greek and Spanish Government bonds in 2012, then jointly known, unkindly perhaps, as the PIIGS economies

Bonds issued by supranational agencies, such as the World Bank or the European Investment Bank, are considered as safe as those issued by central Governments.

Bonds are also issued by lower levels of Government (provincial, state or local authorities) and Government agencies (such as the US Federal Home Loan Mortgage Corporation (also known as Freddie Mac)). However, these are generally not considered to be as safe as Government bonds (and indeed Freddie Mac and a similar US organization, Fannie Mae, were both implicated in the sub-prime crisis which led to severe financial problems across the World from 2007. Both Fannie Mae and Freddie Mac ware placed into the conservatorship of the Federal Housing Finance Agency).

In the UK, Gilts are issued by the Debt Management Office (DMO), an executive agency of the Treasury (this means it is legally part of the Treasury but operates at arm's length from Ministers), using an auction process. Bids above £500,000 are made on a competitive basis, stating the amount and price. Competitive bids are ranked in descending order of price and bonds are sold to those whose competitive bids are at or above the lowest price the DMO is prepared to accept. Bids for less than £500,000 are made on a non-competitive basis. Successful non-competitive bids are accepted in full at the weighted average price at which competitive bids have been accepted.

Overseas Government bonds are usually also issued using an auction process, although the way auctions are conducted differ. The institutions responsible for issuing Government bonds also differ by country. Some Governments have a debt management office, while in other countries responsibility for issuance lies with the ministry of finance or with the central bank.

Index Linked Government Bonds

Governments issue both conventional bonds, with a fixed coupon, and index-linked bonds, where the coupon and the redemption payment are linked to a measure of inflation, such as the consumer prices index (CPI) or retail prices index (RPI) in the UK. This provides protection for the original investment against the effects of price inflation. In response to growing demand from pension schemes for assets to match their inflation linked liabilities, the range of maturity dates has been expanded in recent years, including ultra-long dated bonds with a 50-year+ maturity date now available (2068 is the longest-dated repayment available as per Tradeweb, October 2017).

Corporate Bonds – Investment Grade

Corporate bonds are bonds issued by companies. They are sometimes referred to as "credits". Corporate bonds carry a higher yield than most Government issued bonds, as companies need to offer greater rewards to investors to compensate for the additional risk of default involved. However, a company's bond is still less risky than its shares because if a company becomes insolvent, bond holders rank above shareholders as creditors.

Although less secure than Gilts, most corporate bonds are rated by independent credit ratings agencies to give some measure of the level of security that they can find in a particular issue. The main rating agencies include Moody's and Standard & Poor's. Corporate bonds with a high credit rating are called "investment grade". The highest rating is AAA/Aaa ("triple A"), which indicates that a company is viewed as financially very strong and highly unlikely to default on its payments to bondholders. The lowest rating within "investment grade" is BBB/Baa.

Corporate bonds are usually issued through a placing, whereby a company appoints a lead manager who is responsible for negotiating the terms and conditions (e.g. coupon, maturity, what happens in the event of a default) and the price. New issues are usually priced by reference to a yield margin or spread over that of a Gilt of the same maturity. The lead manager will often also choose an underwriter to guarantee the whole issue.

High Yield – Non Investment Grade

High yield corporate bonds cover the higher risk segment of corporate bonds, in particular those rated as non-investment grade. This segment includes bonds rated BB/Ba and below. High yield issuers have to offer greater rewards than investment grade corporate bond issuers, due to the higher risk of default. They are colloquially known as "junk" bonds.

Emerging Market Debt

Emerging market debt includes bonds issued by Governments and corporations of less developed countries. They tend to offer higher returns to compensate for the increased economic and political risks compared to developed countries. Some of the largest issuers in the emerging market debt segment are Brazil, Mexico and Russia.

2.6 CASH AND NEAR CASH INVESTMENTS

2.6.1 Cash

Cash is a suitable investment for those looking for a short term home for their capital and for those clients with a very cautious attitude to investment risk. Cash provides security for the face value of capital. Given the low risk profile of cash investments, returns are also lower than most other investments.

Future returns from cash are highly correlated to interest rates set by the relevant central bank. The pricing mechanism through the banking system generally results in short term deposit rates that are close to, and track, the official rate.

Beyond short term deposits, there are a number of other money market instruments for investors seeking liquidity and security. Typical investments may include Certificates of Deposit, Commercial Paper and Treasury Bills. These instruments pay interest in a variety of ways.

Like fixed income products, rates of return on cash investments will usually vary depending on the maturity of the instrument (how long your money is tied up) and the credit rating of the issuer. Standard and Poor's highest rating is A-1+ (down to A-3), while Moody's is P-1 (down to P-3).

Cash Management

Cash management techniques have developed significantly over the past decade. While it may still be appropriate in many cases simply to make short term deposits, there are a number of drawbacks to this course of action. The level of interest rates is not always particularly favourable and inflation is constantly eroding the value of the investment. If you are willing to commit to a fixed term deposit, the rate will improve but immediate access to your funds is foregone.

2.6.2 Treasury Bills

T-bills in the UK are promissory notes issued by the Government, pledging to repay a set sum of money at a specified date, usually not more than three months in the future. Treasury Bills are predominantly wholesale instruments with a minimum investment of £500,000 at the UK Debt Management Office's weekly tenders. For a member of the public to purchase Treasury bills they would need to have a client relationship, either directly or through a stockbroker with one of the Treasury Bill Primary Participants who are the major banks that usually bid at the weekly tenders. T-bills trade at a discount to par, or their face value. For example, an investor, if he has a suitable relationship with a Primary Participant, might pay £9,900 for a £10,000 T-bill. In other words, rather than paying a coupon or interest, the difference between the purchase price and the face value represents the yield. Income Tax is payable on the difference gained.

2.6.3 Commercial Paper

Companies with high credit ratings can issue short term debt securities that are very similar to T-bills and are known as commercial paper. Commercial paper is a promissory note, usually unsecured, which companies can use for their short-term financing needs such as re-stocking inventories or managing accounts receivable. With a maturity of up to 270 days, commercial paper can be either discounted or interest bearing and is generally held to maturity, hence there is no established secondary market.

2.6.4 Certificates of Deposit

A certificate of deposit (CD) is an interest-bearing savings certificate. Normally with a maturity of one year or less (though can be longer), CDs have a fixed interest rate, which is paid on maturity. CDs are usually issued by highly rated banks and other financial organisations and can be traded. Occasionally they may be issued at a discount instead of providing interest. The smallest denomination CD is usually £100,000.

2.6.5 Floating Rate Notes

Floating rate notes (FRNs) are debt securities which pay a variable rate of interest. These instruments may be attractive to investors as they offer protection against a rise in interest rates. An FRN usually pays coupons (interest) on a quarterly basis and may include a spread (an amount of interest above the reference rate) over the money market index that it tracks, for example three month LIBOR: the London Interbank Offered Rate, the average of interest rates estimated by each of the leading banks in London that it would be charged were it to borrow from other banks. (There are plans to replace LIBOR by 2021.) The interest rate is reset periodically, often every six months, rather than tracking its index on a daily basis. Some FRNs have maximum and minimum coupon limits.

2.6.6 Liquidity Funds

These funds essentially offer investors the benefits of security, liquidity, competitive returns and operational simplicity. The first European liquidity funds were launched in the mid-1990s and were developed in line with successful US liquidity funds.

Liquidity funds are structured as open ended investment companies (OEICs), and are generally listed in Dublin or Luxembourg. They invest in a diversified range of highly rated money market securities, including Treasury Bills, short term deposits, commercial paper, certificates of deposit and floating rate notes. They have a maximum weighted average maturity of 60 days and typically have a target return of seven day LIBID (London Interbank Bid rate). They are generally rated AAAm – the highest rating accorded to money market funds by S&P – (or equivalent). They are designed to look like a bank deposit, with a constant net asset value (NAV), and offer a dividend, which can be paid monthly (like interest) or reinvested in the fund.
The combination of same day access, competitive returns, AAA credit rating and straightforward operation has resulted in liquidity funds becoming an accepted home for short term cash.

2.6.7 Enhanced Cash Funds

While liquidity funds can provide an attractive alternative to bank deposits for short term cash, they do not always offer a good match for all of a cash investor's requirements. Enhanced cash funds are not constrained by the requirements of an AAAm rating and therefore asset managers are in a position to offer a much wider range of products. Some funds seek to enhance returns by taking greater credit risk or investing in structured products, others focus on seeking returns from increased exposure to the yield curve. The asset manager may also choose a longer benchmark, such as three month LIBID. Alternatively, the benchmark may still be seven day LIBID but with an outperformance target. The funds will usually have a notice period of up to one week for redemptions and possibly also for subscriptions.

This greater freedom for the manager means that the investor needs to look closely at the different funds and managers to ensure that they are both comfortable with the proposed strategy and that they are confident that the fund manager has the expertise to carry it out successfully. The investor also needs to consider the size of the fund, how liquid it is and the number and diversification of the investor base. The selection process will therefore be similar to the process used for fixed income managers.

One of the key differences between liquidity funds and enhanced cash funds is that liquidity funds have a constant NAV, but most enhanced cash funds have to be marked to market daily (because of their longer weighted average maturity).This combined with their longer duration and potentially greater exposure to credit, therefore results in a greater volatility in returns both daily and over longer periods. Adverse market conditions may also cause an enhanced cash fund to underperform a liquidity fund in the short term.

Despite these potential drawbacks, enhanced cash funds offer some major benefits. These include:

- the ability to benefit from longer duration while remaining relatively liquid
- the opportunity to benefit from investment manager expertise
- the economies of scale which come from being part of a pooled fund.

2.7 COMMERCIAL PROPERTY

UK commercial property has performed well in the very recent past following a period of large falls in value since mid-2007. This factor has reignited investor demand for the asset class. The main component of overall returns has been capital growth. In addition to the potential for capital growth – of which there are no guarantees – the asset class offers a number of other attractions:

- regular income: achieved through rents received from tenants
- security of income: UK commercial property leases tend to be long term, typically lasting ten years or more, providing a high degree of income visibility and security, regardless of market conditions
- diversification benefits: commercial property returns have historically had a low correlation with returns from equities and bonds. It therefore offers a means to increase diversification within a balanced portfolio.The asset class itself offers significant scope for diversification. Each sector has its own drivers and opportunities, while different locations, property types and tenants provide further opportunity to spread risk
- equity and bond characteristics: property has certain characteristics in common with both equities and bonds, since it can generate capital growth (like equities) and regular income (like bonds). It also has an advantage over both equities and bonds in that if a tenant fails financially, the investor will still own the property, which it can sell or re-let.

While the potential benefits are compelling, there are a number of risks and other factors that investors need to consider:

- liquidity constraints: commercial property is a relatively illiquid investment. Unlike other major asset classes, property is not sold on a central exchange and completing a purchase or sale of a property is a lengthy process. Opportunities to buy individual properties are dependent on both supply and available sellers and at times when property prices are under pressure, collective investment fund managers may suspended dealings on unit holdings for weeks at a time.
- costs: the costs incurred in buying or selling property are relatively high, with legal fees and tax adding to already high transaction costs. Transaction and marketing costs can often add around 6% to the purchase price and Stamp Duty Land Tax (SDLT) is 5% on purchases of freehold properties, valued at over £250,000, for example. SDLT is covered in more detail in Part 2 of this study manual.
- management and maintenance: actively managing commercial property requires specialist skills. In addition to managing tenants, commercial properties need to be maintained to an acceptable standard in order to preserve their capital value. These are ongoing costs which will need to be taken into account

- economic influences: commercial property is a cyclical market and influenced by the different stages of the economic cycle. Given the time required to complete new developments, there is the risk that the economy could take a significant downturn before new projects come into fruition, as seen in the early 1990s
- valuation: there are no daily listings of market prices for properties, merely expert opinions as to the likely value of certain standardised types of property from month to month or quarter to quarter. The market is characterised by a few transactions involving large sums, with restricted information regarding the prices and conditions involved. There is, however, a comprehensive database of institutional property, including property details, transaction prices and valuations (the Investment Property Databank)
- Government intervention: the Government's tax policy on rental income will affect the overall value of property investment. Other factors, such as projects to build motorways or high speed railway lines, or the property's location in an Enterprise Zone where inter alia business rates relief can apply, may have a bearing on the value of a property. So too might new requirements such as that for the preparation of Energy Performance Certificates which have been required since October 2008: not only is the energy efficiency rating of a building to be shown but also from April 2018 the granting of new leases will not be possible for the lowest rated properties.
- overseas property: practices and traditions in other countries can be quite different from the UK and local advice should always be sought when considering an overseas property purchase or sale.

27.1 Retail

Retail is the largest of the three sectors. It includes not only shops and shopping centres, but out-of-town developments and retail warehouses. The key driver of the sector's performance is consumer spending. Retail property can be owned on a freehold or leasehold basis. Shopping centres are often long leasehold, with local authorities retaining freehold ownership; standard shop units will usually be freehold, although leasehold interests exist in some high quality high street retail properties; and retail warehouses are almost always freehold.

The value of a retail property is largely dependent on its location and size, which together create a shopping catchment. Proximity to transport facilities and/or parking will mean greater convenience for customers, hence higher turnover and a greater rental value for the property.

27.2 Offices

The office sector includes standard offices and business parks and tends to be more cyclical than retail, since its performance is driven by the strength of the business environment, particularly in London. Offices may be classified into "in town" and "out of town" and can be owned on a freehold or leasehold basis.

The lease terms will also be vital in determining value. For example, long leases are more valuable than short leases.There is a significant fall in value when less than ten years is left on the lease, and "break" clauses (where the tenant has an opportunity to be released from its tenancy obligations) also depress value.

While rental values were high in the late 1980s, severe falls in rental value during the early 1990s recession resulted in many offices being "over-rented". Over-renting occurs when the rental value of a property falls below the level of rent paid. Hence the relationship of the rental value of the building to the contracted rent defined by the lease is crucial in determining the value of the investment.

The rental value of an office per unit of space is also dependent on its location, age, quality of finish and provision for parking.

273 Industrials

With the trend towards outsourcing industrial production overseas, property used for manufacturing purposes accounts for a relatively small proportion of the industrial sector. Industrial property is increasingly used for logistics, storage, retail or quasi retail activity. As a result, drivers of the sector's returns are varied and include both the state of the manufacturing sector and retail activity.

Industrial property includes traditional factory units, specialist industrial buildings and more modern distribution warehouses owned on a freehold or leasehold basis. It can be bought in single units, such as a factory, or in multiple units, such as a trading estate. Some industrial buildings are designed with a specific use or at best a limited range of possible uses in mind. Consequently, these buildings will appeal only to a limited range of end users. Others are simple framed constructions which are flexible and versatile.

Industrial property has developed traditionally along the lines of transportation that were popular and relevant at the time of its construction. For example, most mills were alongside water sources such as rivers and canals, while modern all-purpose warehouses used for storage and distribution tend to be close to motorways. In each case, the obsolescence of a form of transport or energy may make obsolete a complete area of industrial properties.This makes the location of any industrial property its principal feature.

Outside the three main sectors, there are also a number of smaller market segments, such as leisure, hotels and agricultural property (particularly agricultural land given its importance in food production). All property types are further classified as prime or secondary, determined by the quality of the building, the location, the lease and the tenant.

London and the South East are the dominant regions of the UK market, with the highest concentration of offices and industrial properties. Often a property trend in London e.g. revitalisation of the rental market, will ripple out to the provinces, particularly the major cities. Given the limited space for new construction in towns and cities, together with Government restrictions on developing the countryside, supply is inelastic, particularly in the South East.

2.8 RESIDENTIAL PROPERTY

Although investors will naturally be more familiar with residential property, it is a very different asset class from commercial property, both in the way it behaves and the returns it generates. Residential rental agreements will typically be with individuals and for only six months or a year: assured short hold. Longer leases tend to depress property values and an increased number of buy-to-let properties have meant that finding tenants and maintaining income levels is becoming more difficult. This means the income stream available on residential properties is less reliable and therefore investment in residential property tends to be more geared towards capital growth. Some older leases are "secure" and here the limitations on changing the amount of rent and inability to renew the tenancy agreement after, say, six months, will severely depress capital values. Secure tenants may also have succession rights.

Net income is typically lower than from commercial property once management fees, maintenance and insurance costs and empty letting periods are factored in. Investors are also vulnerable to volatility in house prices. Housing sector downturns are often associated with high interest rates, as in the early 1990s. Buy-to-let investors may find that outgoings on mortgages are at their highest when property prices are at their weakest.

As with commercial properties, the main drawbacks of residential property investments are the lack of liquidity, the costs associated with managing the property, and void periods when a tenant cannot be found.

Letting a residential property should be regarded as a form of business that requires administrative, financial and marketing skills. It also involves commitment and patience with the customer, i.e. the tenants and can give rise to unexpected and inconvenient calls on the investors' time to resolve problems. Investors in this area will need to decide whether to manage the properties themselves or to engage a specialist lettings and management agency. If an agency is used the fees charged can vary significantly. Some may charge fees based on a flat rate of between 10% and 15% (+VAT) of the rents collected while others may charge a fee for letting the property in addition to a collection fee. HMRC's changing and less favourable approach to buy-to-let properties also needs to be taken into account.

There are regional variations in both income returns and capital growth, and a number of factors need to be taken into account when choosing a property that is appropriate for letting. These include:

- *Location* – where a property is situated can make substantial differences to values and prospects for growth
- *Tenant availability* – the local letting market should be investigated before any purchase is made to ensure that there is a demand for properties to let
- *Tenants* – consideration should be given to the type of tenant that a property is aimed at
- *Age and condition of the property* – this will determine the type of tenant attracted and the income from a property. If money needs to be spent on maintaining a property, this may reduce or eliminate any income it produces.

One of the main attractions behind investing in the buy-to-let market has been the prospect of long term capital growth. Although property prices in the past have risen considerably more than inflation, this is not always the case. This has been seen in recent years where house prices in the UK have fallen or, at best, remained static as banks and building societies tightened their lending criteria, making it more difficult for people to obtain a mortgage.

2.8.1 Mortgages

For most people, the only way to enter the residential property market as a property owner is to borrow money. A young couple wishing to build their lives together or mature people who wish to remain single will at some stage wish to live independently of their families and not want to pay rent. Their route forward is to buy their own home to live in.

Landlords too for investment reasons may wish to own further property, while entrepreneurs for business reasons may wish their business to own the premises from which they trade or where they manufacture their products. Whatever the investor's motive, the general principle is the same: how do you buy a property when you do not have the cash needed? The short answer is to obtain a loan. The circumstances of home-buyers, landlords and entrepreneurs may be different and the loans may be made by very different lenders (Private Equity which we look at in a in 2.11 below is another way for businesses to raise capital) but the solutions and principles which apply for own home buyers have their parallels for landlords and businesses. The adviser, unless he specialises in business loans, is unlikely to become involved with other than domestic mortgages so we will now look at this specific aspect in further detail.

In the Retail Advice and Regulation unit we consider the place of mortgages and interest payments as part of holistic-advice. Here we will look at the basics of mortgages.

Legally a mortgage is the security which the lender holds and which is attached to a property by a Legal Charge. The lender is the person holding this Charge: he is the mortgagee. The borrower is the mortgagor: the borrower by means of the Legal Charge transfers away the legal ownership rights of part of the property; nevertheless, provided the borrower repays the loan and interest due on that loan then once the debt is paid, the Legal Charge, i.e. the mortgage, is released. If the borrower fails to repay the loan then the lender can "foreclose" on the mortgage and enforce a sale of the property obtain back the outstanding loan monies and interest (pursuant to

the terms and conditions of the Legal Charge). Paradoxically, most people when they say they have a mortgage are actually referring to their loan which the mortgage process initially secured. But semantics aside, the adviser needs to understand the debt and debt-servicing, largely interest payments, figures involved.

Where a mortgage has been agreed, the Charge on the property, which is registered at the Land Registry, means that the property itself acts as security for the loan. Older mortgages frequently were accompanied by a Collateral Charge, whereby the lender required additional security in the form of an endowment policy which was the method of repaying the loan: another complication for advisers to look out for.

For those new home owners lucky enough to be able to draw on the bank of mum and dad the loan may be unsecured. In other words, the new home owners simply pays for his new home with the finance provided by his parents, who may perhaps not insist on a Legal Charge. If parents are only providing a deposit then this may be unsecured while the main loan is subject to a Legal Charge. Where a commercial lender is lending most of the purchase price but where the parents require a Legal Charge, the commercial lender will insist on taking a First Charge with the parents needing to accept that their Second Charge will not take precedence over the First Charge in the event of a loan default.

Any deposit paid by the borrower in practice means that he has "Equity" in the property: Equity represents the home owner's legal interest in the property after all secured loans and interest have been repaid. It is this right which lends its name to Equity Release, whereby older home owners can borrow money against this right and continue to live in their home.The terms of these Equity Release contracts are the subject of specialist advice.

Some home owners who have significant Equity in their property may decide to borrow more money and take out a further loan using some of this available Equity. In these circumstances, for additional finance, they may approach either the first lender to see if their existing agreement can be amended or a new lender. If the existing lender agrees then a Remortgage can be arranged. A remortgage might also be agreed with a new lender who provides better terms for the borrower: lower interest payments perhaps either because the interest rate is lower or the repayment term is longer. At other times a borrower may decide to, or may have to, leave his first mortgage unchanged. However, if he still requires more cash and has sufficient Equity then a second lender may be prepared to lend further money, perhaps even exceeding the Equity value on the expectation that house values will continue to ruse, by means of a second mortgage which will as the name implies be settled after the first mortgage has been released. A second mortgage may require a higher interest rate to be paid and may have a different repayment term.

Any loan that is taken out, by means of a mortgage (or otherwise), needs to repaid. The initial terms will specify the interest rate: this may be variable from outset, changes depending on the general level of market interest rates. Or the loan provider may agree to fix the rate of interest for an agreed period to help the borrower to budget. Nowadays most loan repayment contracts involve a repayment of capital sum borrowed. Endowment mortgages mentioned above or pension mortgages which use protected tax free cash are possible alternatives where capital is repaid at the end of the loan period – these types of loan are known as "interest-only". Where a repayment loan is involved the amount of capital repaid each month consists initially of almost all capital. This is because interest is due on the whole of the capital borrowed and only a very small portion of capital is repaid. Over the term of the mortgage, the amount of capital repaid each month progressively increases.

When a mortgage is being established the borrower initially may not have a deposit available. It may be in an account which has 30-day access terms or it may be necessary to sell other assets. If such circumstances apply then the borrower may ask his bank for a short-term loan to bridge the period from when he has found his new home and needs to exchange contracts to when he completes on the contract and the remaining purchase monies are available.The bridging loan would be repaid at the time of completion.

Mortgage advice is in itself a specialist subject and advisers would need either to obtain specialist accredited qualifications themselves or use a colleague or business partner who has appropriate qualifications and experience.

29 WAYS TO INVEST IN PROPERTY

You can invest both directly and indirectly in property. When looking at commercial property, direct investment tends to remain the preserve of larger investors, since costs per unit are high. It may also be less liquid than an indirect approach. Indirect investment can be achieved via a Unit Trust that invests directly in property or through investing in shares or bonds of property companies. Smaller investors may find an indirect route more appropriate as buying and selling units can be easier and quicker than trading individual properties.

29.1 Property Shares

Compared with direct investment in property as discussed in 2.7 and 2.8 above, investing in the shares of a property company is a more liquid means of gaining property exposure, since shares can be bought and sold easily. Most providers and investment houses offer a choice of funds which invest in property. However, when the property market is depressed the property fund managers may reserve the right to suspend dealings in the property shares or units.The performance of property shares tends to have a greater link to the performance of the equity market than a direct property investment. This is particularly true if the investment is in a company which itself invests in property companies and has borrowed heavily to make investments. (There is less volatility if the investment is made directly in the organisation which owns the "bricks and mortar" – see 2.9.3 below.)

29.2 Open Ended Investment Companies and Unit Trusts

Open Ended Investment Companies and Unit Trusts that invest directly in property tend to have a lower correlation to the stock market but may be less liquid. Investors pool money to buy properties and each unit represents an equal share of the underlying assets. As the value of the properties changes (after deduction of the relevant expenses for maintaining the property portfolio by the managers), so does the value of each unit. In times when the property market is depressed, dealing in property units, especially the sale thereof, can be suspended on the basis that it is impossible to find a buyer for a property, which is within the fund portfolio, at a price which does not prejudice the long-term interests of the unit-holders in general.

29.3 Real Estate Investment Trusts "REITs"

1 January 2007 saw the introduction of REITs in the UK. The key advantage of REITs, which can invest in both commercial and residential property, is that they can be traded on stock exchanges and are therefore a comparatively liquid investment unlike the underlying real estate. They are also an easy way for investors to invest small amounts of cash in, say, a commercial property which would otherwise be inaccessible to them for investment purposes. Originating in the United States some 50 years ago, they also aim to invest directly in property so in effect the REIT owns and operates the "bricks and mortar" concerned. A UK REIT must distribute 90% of its net profits to shareholders as a dividend, paying no more than 10% of its dividend to any one shareholder. To become a REIT, a company must be listed on a recognised exchange and be regulated by the FCA. Property companies – or companies with significant property assets – can convert to REIT status, subject to meeting a number of requirements, in order to avoid paying Corporation Tax on the profits of property sales.

Offshore property companies also distribute income to investors gross of tax.

2.9.4 Limited Partnerships

There is also the option to invest via a limited partnership, but these typically set minimum investment periods of several years. In this context a Limited Partnership is a way for individual investors to join tighter and pool their resources to take advantage of investments they would not be able to make as individuals. It could be regarded as a mini collective investment scheme and we consider collective investment schemes in the next Chapter.

2.10 CURRENCY

Currency risk has become increasingly relevant as investors seek to gain from the benefits of diversifying their portfolios by expanding their equity and bond exposure beyond the UK market.While this diversification makes a good deal of sense in terms of general risk reduction, the risk of adverse currency movements is accentuated. If an investor wants exposure to US equities, for all intents and purposes he must buy those stocks in US dollars and then hold them as US dollar stocks. The implications of this are clear if one compares the returns from a benchmark index such as the S&P 500 in local currency terms against the returns in sterling during a period of exchange rate volatility. For example, if the S&P 500 index rises 10% over the course of a year, but the dollar weakens against sterling by the same margin, the net result for UK investors is a 0% return. An actual example was seen with Brexit: ignoring the initial sharp fall in the FTSE 100, the main UK index increased noticeably in Sterling terms. But because Sterling had fallen in value, the higher FTSE 100 index levels were in essence showing little change in US $ values.

Currency Management Styles

Broadly speaking, currency risk is managed either on an active or passive basis.

Passive currency management is more often referred to as hedging. This strategy does not seek to enhance returns from the portfolio but simply aims to remove the risk in holding securities based in another currency. In effect, it removes the uncertainty concerning which direction exchange rates might move. Hedging is usually achieved through using derivatives, such as a forward, a currency option or a currency swap.

Active currency management actually seeks to profit from trading in currencies by exploiting changes in exchange rates. Uniquely among financial markets, this puts it at odds with the majority of participants in the market who do not seek a profit through buying and selling currency.

Among the biggest traders of foreign currency are central banks, which may enter the market to limit volatility in the exchange rate. Other participants, such as tourists or companies and institutional investors hedging their currency risk, are not seeking to generate profits.

Managers dealing in currencies utilise a number of techniques to predict the course of currency movements. They may attempt to determine the economic fair value of a currency and exploit this by selling those currencies that appear overvalued and buying those that appear cheap. Alternatively, analysis of past currency movements can be made to predict future patterns.

Interest rates have a huge bearing on currency movements. National Governments and central banks can offer higher interest rates to attract foreign money and this will tend to improve the exchange rate for their currency. Conversely interest rates may be lowered to deter too much foreign capital coming into the country:The Swiss National Bank introduced a deposit rate of -0.25% percent on deposit account balances above 10 million Swiss francs at the central bank, effective 22/01/15, aiming to stem the increase in value of the Swiss franc, the Russian financial crisis and the start of EU Quantitative Easing having increased demand for safe assets, putting pressure on the franc.

2.11 PRIVATE EQUITY

Private equity investment is defined as "investing in securities through a negotiated process", according to the European Private Equity and Venture Capital Association (EVCA). It usually involves investing in unquoted companies, but it also includes acquiring more mature businesses (buy outs) and financing debt. Since private equity (or venture capital) investment requires specialised skills in such matters as assessing start-up businesses, helping develop these businesses and managing/restructuring mature businesses, investors usually make indirect investments through private equity (including venture capital) funds or funds of private equity funds. However, wealthy individuals – often entrepreneurs, friends and relatives – might buy shares in private companies.

Private equity investments include:

- venture capital: investments in unquoted companies with undeveloped products or marketing, aiming to make profits by selling their holdings into the stock market through initial public offerings. Stock markets usually require companies to satisfy certain size and earnings criteria in order to grant listing and therefore, venture capital firms help the management of unquoted companies they invest in to grow their business to achieve these criteria
- replacement capital: purchases shares from another investor to reduce the debt level via refinancing
- buy out: acquires a majority of shares in mature companies, subsidiaries or business units
- special situation: includes investing in assets such as distressed debt, project finance and other one-time opportunities. "Mezzanine debt financing" invests in subordinated debt, the latter being a loan or debt which ranks below other types of debt in event of borrower default.

Investing in private equity tends to offer the investor the opportunity to generate higher absolute returns, while improving portfolio diversification. Data from the US over 20 years shows that in the long term, private equity has outperformed public equities on the whole, although performance of private equity funds tends to be much more diverse than that of listed equity and bond markets. This has also been the case in Europe over the last ten years. However, more recent analysis has suggested that the additional returns from investing in private equity may be mainly the consequence of the gearing achieved through relatively cheap debt finance. Managers of private equity funds seek absolute returns and are highly motivated towards achieving net cash returns to investors.

A variant of Private Equity which has appeared in recent years is Peer-to-Peer Lending (P2P), where savers can lend money to another person, probably unconnected. The amounts involved for savers are small compared with the total investment being sought by the borrower. In other words many savers are needed to match one borrower's needs: this feature has given P2P lending the name "crowd-funding" which used to be regularly used in its early years. Zopa started the World's first crowd-funding venture in the UK in 2005. Since then it has progressed significantly, worldwide. According to the Peer-to-Peer Finance Association (P2PFA) its members represent about three-quarters of the UK P2P market. P2P investing is generally effected on line, facilitated by members of P2PFA. It has gained popularity as savers strive to get a return better than the rates currently offered by banks and building societies. But P2P investing is risky. Although the FCA have regulated P2P lending since 2014, P2P investments are not covered by the FSCS.

2.12 COMMODITIES

Commodities are increasingly becoming a part of an institutional investment portfolio. As well as providing potentially attractive returns for investors, commodity prices are largely uncorrelated to those of other investments, facilitating an extra layer of diversification in a portfolio.

Commodities can be broken down into two main groups: "hard" and "soft". Hard commodities include precious metals, industrial metals, oil and coal. Soft commodities refer to agricultural produce, such as wheat, coffee, sugar and cotton. Investment in these assets is rarely done directly, given the impracticalities of taking delivery of such goods and selling them on. Instead, most money is invested through commodity derivatives, particularly in the futures market.

Commodity prices are broadly determined by supply and demand pressures and can be volatile and hard to predict. Soft commodity prices, for example, can be severely affected by adverse weather or other climatic influences. Meanwhile, oil prices are affected by global economic activity and perceptions of geopolitical concerns, while gold is linked to inflation, political uncertainty and the activities of central banks in relation to their reserves.

2.13 ALTERNATIVE INVESTMENTS

As rates for savers in traditional bank and building society accounts have fallen to all-time lows, other investments are being sought and used. Commodities were mentioned in the previous section and P2P lending at the end of the Private Equity section 2.11, both Private Equity and P2P being alternative forms of investment to the long-established Equity and Fixed Interest markets used by those investors prepared to take some risks with capital.

Alternative schemes will inevitably be promoted when more traditional forms of investment are seen lacking in some respects. Currently, it is not unusual to see promotions for woodlands, gold and other precious metals, diamonds, wind farms, solar farms, overseas property developments, second-hand US life policies, wine … the list is as long as people can come up with ideas. Investors and their advisers will see many glossy brochures explaining why an investment has to succeed. But extreme care is needed, both by the investor and his adviser. Remember: US home values reached dizzy heights in mid-2006: they were regarded as excellent investments and to enable people worldwide to benefit from future soaring prices the right to receive income from the US borrowers' mortgage payments was collateralised into packages which were sold across the World: an investment as safe as houses … but perhaps only safe for the sellers of such packages. The sub-prime crisis hit and by early 2009 some commentators opined, as a result of Stock Market crashes triggered by the loss of confidence following the fall in value of over-priced American homes and subsequent default, that the capitalist system was doomed. The ramifications of the investment falls in 2007/9 are highly complex. And while the future failure of one poor investment in what started as a fine-sounding renewable energy scheme is not going to trigger a financial crisis, the risks of alternative investments should never be underestimated. The question: "Are they as "safe" as American houses?" is one that has to be addressed.

Summary

Individuals, trusts and other organisations have various ways in which they can invest. These investments can be broken down into a number of principal asset classes, including: equities (UK and Overseas), bonds (fixed interest and index-linked), cash, property, currency, commodities and alternative investments. In this Chapter we have looked at the characteristics of these asset classes.

Self Test Questions

- In the event of company liquidation, where do ordinary shareholders rank in terms of repayment?
- How do interest rates, inflation and supply and demand affect the capital value of bonds?
- Why do corporate bonds offer higher yields than Government bonds?
- Rank the following asset classes in terms of their absolute risk characteristics, from lowest risk profile to highest: property, equities, bonds, cash.

INTRODUCTION

In the previous Chapter we looked principally at the main asset classes that can be used by investors making direct investments. Direct investment is more likely to be suited to portfolios of at least £100,000. Where individuals are looking to invest smaller amounts, indirect investments, i.e. collective or packaged investment products such as Unit Trusts/OEICs, are likely to be more suitable.

In this Chapter we will first look at the differences between direct and indirect investments.We will then look at indirect investment products including pooled investment vehicles, tax efficient savings vehicles and the derivatives market.

3.1 DIRECT INVESTMENTS

Direct investments are most likely to appeal to investors who have a significant amount of money to invest and who are willing to accept a reasonable amount of risk, because unless the portfolio is large, it is likely to have greater volatility in the returns it produces. However, the portfolio can be tailored to the investor's personal requirements as it will be easier to include or exclude certain stocks. It may be more expensive to run a direct portfolio until it reaches a significant size. Charges and the level of service required are aspects which the investor will need to consider with his adviser. Time is also a factor: some investors making direct investments are content to and probably enjoy spending time researching their investment: for others the receipt of company Accounts etc. and dealing with dividends is not welcome.

Perhaps one of the most popular and well-known direct investments in recent decades has been buy-to-let property. Some investors have done extremely well which has increased general interest in this medium. But others have not been so fortunate: problems with tenants, expensive repairs, void periods, repossession and significant hassle. A moment's reflection by the student on the pros and cons of buy-to-let, and then consideration of how these pros and cons might in general terms apply to other direct investments, will be worthwhile. The central issue is that an investment in a single asset has a relatively high degree of risk compared with the same quantum of investment made across a number of assets through a pooled investment vehicle.

3.2 INDIRECT POOLED INVESTMENT VEHICLES

Where an investor has a small portfolio, it is normally easier and less expensive to spread risk through indirect investments. By using a collective investment scheme a small investor can take advantage of the economies of scale produced by all the investments held in the fund and risk can be reduced because this investment can be diversified to a greater extent. The investor can choose to get exposure to a particular market by selecting a collective investment scheme that gives exposure to that market.

A pooled investment vehicle or collective investment scheme (CIS) enables investors to invest in a wide range of assets to which their funds would be too small otherwise to gain access. A CIS pools the resources of a number of individual investors and invests these in a specified type or range of assets. Each investor will own shares or units in the scheme.

These schemes can have varying investment objectives, such as income generation or capital growth. The pooling of resources provides certain benefits to investors:

- diversification: reduction of risks through investment in a wide range of assets
- reduced costs: dealing in bulk can lead to a reduction in costs.

There are various types of investment vehicles which we will look at in the following sections.

3.2.1 Unit Trusts

A Unit Trust (UT) is a trust set up as a pooled fund usually under the supervision of the Financial Conduct Authority (FCA). Its portfolio of investments is divided into units to enable investors to buy into the trust or to sell an earlier investment. Unit trusts are "open ended" funds, which means that the fund expands as more people invest and contracts as people remove their money.

The price of a unit depends on the net asset value of the underlying assets. An increase in the value of the underlying assets leads to a rise in the price of a unit. Prices can be quoted one way (the same price to buy or sell units) or two ways (a higher price to buy, "the offer price", than to sell, "the bid price"). The difference between the two is the "bid-offer spread". For one way priced funds, charges are set out separately. For two way priced funds, the charge is incorporated in the difference between the purchase price and the net asset value.

UTs can be authorised or unauthorised. If a UT is to be marketed to the general public it must be authorised by the FCA. Where a UT is authorised, the FCA regulates both:

- trustees, managers, marketing and management, and
- advisers and designated professional bodies (e.g. accountants and solicitors who give advice as an incidental part of their business).

The most common form of unauthorised UT is the exempt UT which is:

- operated mainly for pension funds and registered charities
- free from CGT on disposals within the fund, and
- subject to Income Tax and not Corporation Tax.

The structure of a UT allows for the fund manager to deal with the underlying investments and inflows & outflows of cash on a daily basis. The responsibility for supervising the work of the fund manager rests with the trustees who are the legal owners of the UT. When CISs started to rise in popularity some four decades ago, if people were not investing through insurance companies, as providers tended to be referred to then, chances are they would be using UTs. In the last decade or so, Open Ended Investment Companies have become much more popular.

More recently UTs have increasingly moved towards a "single swinging price" structure, where there is no explicit bid-offer spread as set out above, but the price swings between bid and offer bases depending on flows in and out of the fund at the time of dealing.

3.2.2 Open Ended Investment Company (or Investment Companies with Variable Capital)

An Open Ended Investment Company (OEIC) is a pooled fund that works in a similar way to a UT except it is structured as a limited company (plc) in which investors can buy and sell shares on an ongoing basis. An OEIC can be an "umbrella" structure holding sub funds with different investment objectives. Every sub-fund can offer different share classes with different fee structures for different types of client. OEICs are open-ended funds, which means that the sub-funds expand as more people invest and contract as people remove their money. OEICs, also known as Investment Companies with Variable Capital (ICVC), had their origins on the Continent in SICAVs, or Société d'Investissement À Capital Variable from where the name Investment Companies with Variable Capital comes.

The price of a share depends on the value of the underlying assets. An increase in the value of the underlying assets leads to a rise in the price of a share. OEICs are usually priced on a single swinging price structure (see last paragraph of previous section).

3.2.3 Investment Trusts

An investment trust is a pooled fund which is structured as a company and which issues shares. These shares can be bought and sold on the London Stock Exchange. Unlike UTs and OEICs, an investment trust is a "closed ended" fund, which issues a fixed number of shares. The size of the fund does not expand or contract. In a closed ended fund, the price of a share also depends on the value of the underlying assets. However, as only a limited number of shares are issued, the price of a share also depends on the demand for the fund's shares. This means the price of a share can move independently of the value of the underlying assets.

In contrast to UTs and OEICs, investment trusts can borrow money to invest. This creates gearing, because by borrowing the investment trust manager increases, i.e. "gears up", the amount of cash at his disposal enabling him to enhance the gain to be made on his desired purchase (assuming of course he makes the right decision!). Investment trusts do not fall under FCA restrictions on collective investment schemes, but are governed by the Companies Act and stock exchange listing requirements.

3.2.4 Absolute Return Funds

The inherent volatility of equities, illustrated most clearly by the "dotcom" bubble of the late 1990s and the two subsequent bear markets of 2000-03 and 2008-09, have led to increasing investor demand for funds with more predictable returns. Investors wanted an investment vehicle that could generate consistent, positive returns, regardless of whether the underlying markets were rising or falling, and one that could do so at lower levels of risk than traditional funds. These risk/return characteristics are those typically offered by absolute return funds.

In simple terms, an absolute return fund aims to generate positive returns in all market conditions, whereas a traditional equity fund seeks to generate returns **relative** to the equity market. The concept behind absolute return funds is that they seek to mitigate these fluctuations, aspiring to give investors a clearer idea of what **absolute** returns they might expect.

Of course, merely generating a positive absolute return is not enough to entice most investors. Therefore, an absolute return fund will often have an annual target that it aims to achieve, or exceed, which is typically set at 2-4% above the cash rate, or above inflation. The cash rate in this case is usually measured by LIBID, the wholesale deposit rate (discussed in sections 2.6.6 and 2.6.7).

Absolute Return v Relative Return

On the surface, it is the focus on a target absolute return that distinguishes absolute return funds from their traditional – or relative return – peers. Whereas the former aims to achieve a defined target on an annual basis, the objective of the latter is to outperform a benchmark index that most closely encapsulates their investment universe. For example, a fund that invests in UK equities will usually aim to match, or beat, the returns from the FTSE 100 or FTSE All Share indices. This traditional approach means investors may experience either positive or negative returns, but this is largely dependent on the direction of the markets. While outperforming, the market can deliver strong returns when equities are rising, outperforming in a falling market may seem a fairly meaningless measure of success for an investor.

Absolute return funds, however, generally aim to offer a positive return and some form of capital (or downside) protection.

How Absolute Return Funds Aim to Achieve Their Objective

Absolute return funds come in various guises. Some are based largely on fixed income assets, while others mainly invest in equities and equity derivatives (we consider derivatives further in section 3.3.3). There are also those that use asset allocation methods to achieve their goals. This may be done through the use of alternative assets, including currencies.

To produce positive returns in all market conditions, the fund manager has to have the flexibility to use investment techniques beyond those used by traditional "long-only" fund managers. Long-only funds are those that invest in assets on the basis that they will go up in value. Absolute return funds may allow managers to benefit from short selling, which in effect means positioning to benefit from a fall in value of a particular asset, asset class, sector, market, etc.

The use of derivatives may imply greater risk in the eyes of some investors, but these instruments are often used to hedge certain risks out of portfolios for example, adverse currency movements when investing in overseas assets (or when trading in a foreign currency when you are a manufacturer with no interest in investment issues merely wishing to obtain a known price for your goods abroad). At the same time, derivatives can be used to add value to a fund if a particular currency, asset, sector or market falls in value. Absolute return funds often take both long and short positions in order to isolate risk and maximise returns.

Another potential benefit of using derivatives is that they can reduce the costs of trading in the portfolio. For example, if a fund manager wants exposure to a particular equity sector he can purchase one derivative, such as a future, rather than buying a basket of stocks. This in turn means that tactical asset allocation changes can be implemented swiftly, maximising any potential gains derived from this portfolio rebalancing.

Multi-asset or Asset Allocation Absolute Return Funds

Diversifying a portfolio helps spread the risks associated with any one class of investment. Multi-asset or asset allocation funds seek to meet their objective by investing in a broad range of assets. In addition to the traditional asset classes, such as equities, bonds and cash, these products may invest from time to time, or on a structural, sustained basis, in commodities, property, currencies, or structured products – often using funds or vehicles managed by other providers. Investment risk may be further diversified through varying investment across a number of regions.The manager is able to achieve a positive return in all market backdrops because the returns from these assets have a low correlation or are completely uncorrelated.

Asset allocation funds tend to have unconstrained investment strategies, meaning that managers have complete freedom to move between asset classes to achieve the optimal blend of investments for different market conditions. Managers depend on a combination of market returns, asset allocation and management skill/timing to achieve their objective. These funds often have a predominantly long exposure, meaning that they are exposed to the direction of the underlying markets.

Long/Short Funds

Traditionally, fund management has been based on identifying assets that are expected to appreciate in value, thereby realising a gain for the investor. In other words they are held for the long-term. However, as financial markets have developed, investors have devised new ways of incorporating disfavoured stocks into an investment strategy, either as a means of generating profit or hedging risk. This technique is generally known as "short-selling" or "shorting", whereby an investor can use various techniques to benefit from a fall in an asset's value. The term "short" has been used from the 1800s and "short" is used because the short-seller is temporarily in a deficit position re the shares he is "shorting".

A long/short fund combines long and short positions in individual companies' securities and thereby seeks to exploit both rises and falls in asset prices.

There are various ways to achieve a short position. The purest form of shorting is to borrow a security from a counterparty, such as a broker, index fund, or custodian, and sell that security to a third party with an agreement to buy it back at a later date and return it to the counterparty. In that way, if the short-seller's expectations for the

falling price of that stock are correct he will make a profit without having to lay out any capital. (In practice, a short-seller will be an experienced investor and he will have set up already a suitable account and arrangements for his dealings.) So, given the short-seller's expectations for the falling stock price are correct, a profit is made as the stock falls in value from the point when it is sold to the point when it is bought back again. Of course, there is a risk that the reverse happens and the short-seller has to buy the stock back at a greater price than he sold it. The possible loss could be substantial, whereas the maximum gain will be the difference between the sale price and zero (if the share becomes worthless). However, the short-seller is unlikely to enter this arrangement unless he is confident of making a profit (the counterparty on the other hand makes a small profit with minimal risk).

Examples

Shares not owned at outset: Investor A is convinced that the price of Short Cell (Trading) plc shares is going to fall substantially. Investor A has visited the country where Short Cell (Trading) plc does a lot of its business and the political developments in that country, A feels, are going to change imminently to adversely affect Short Cell (Trading) plc's business interests. As the first step, Investor A therefore borrows 5,000 Short Cell shares which are currently worth £1 each. Secondly, he makes an agreement to sell these at their current £5,000 value. Meanwhile the political developments A has expected come to fruition: the country where Short Cell trades impose significant embargoes and restrictions on Short Cell's activities and the price of their shares plummets to 60p a share just three days later. Finally, A therefore buys 5000 shares for a total cost of £3,000, passes these shares as agreed back to the person he borrowed them from and enjoys his £2,000 gross profit. There will of course be costs to pay including the "borrowing" fee and he will have needed to set up a suitable dealing account (as mentioned above).

Shares owned at outset. Short trading may also be done when the investor also owns the shares being "shorted". In these circumstances the trade is known as "covered". Let's assume that Investor B holds these shares, that he also is aware of the pending political changes but believes that these changes are short-term only and that in the medium term the Short Cell shares are a good investment. As with Investor A, B sells them as the first step but when he makes the repurchase as in the above example this puts him back in the position he was at outset (i.e. owning 5000 Short Cell shares) but having made a £2,000 profit, ignoring costs.

If the shares "shorted" do not fall as expected but increase in value then the investor will suffer a loss, possible quiet significant, when he has to buy shares to return to the party from whom they were borrowed. The risks involved in this scenario are of course significantly reduced if the short trading is "covered" as in the second Example above.

There are various controls a fund manager can put in place to manage such risks (as in the "covered" position above).

One such control strategy is to invest in a balanced combination of long and short positions, generally in similarly performing stocks, which are known as pair trades. For example, a fund manager may go long in Pharmaceutical Stock A, which appears undervalued* or has a catalyst for positive share price momentum. At the same time, he might short Pharmaceutical Stock B, which has a valuation that looks stretched*. Alternatively, the fund manager may take a long position in Stock A but hedge some of this risk by buying a derivative (such as a future or swap) that will deliver a profit if the pharmaceutical sector, or perhaps the FTSE 100 index, falls. The net result of these types of trade means that the effects of general market movements are minimised, while the performance of one stock relative to another (or the sector/index) is enhanced. This type of strategy allows for greater investment precision, by isolating solely the risk that a fund manager actually wants.

* The manager might have formed his opinions on the two pharmaceutical stocks because he knows historically their values have tended to move up and down in a very similar way and medium term he expects that equilibrium to return. The manager could equally come to a similar conclusion on a "pair" of Japanese car shares or a "pair" of oil shares: pairing often involves investing in the same type of stock.

A directional long/short strategy involves taking a net long or short position in a market, reflecting the manager's view on which direction that market will move. A net long position (whereby the manager holds more long positions than short positions overall) benefits from a market rise, while a net short position (where more short positions are held than long) will benefit from a decline.

Equity Market-neutral Funds

In contrast to directional strategies, equity market neutral funds are relatively low risk, given that they seek to neutralise as much market risk as possible. This type of fund is particularly suitable for investors who want a relatively low volatility way of reaching their investment targets, while maintaining some equity risk.

Other Absolute Return Investment Techniques

Absolute return managers are able to exploit a wide range of investment techniques that have not been widely used by traditional funds in the past. Some of the other most common methods include:

- **Volatility strategies** – the pricing of financial options and other securities with embedded options (e.g. convertible and callable bonds) depends on expectations of future market volatility. Funds that can take both long and short volatility positions may be able to benefit from in the market's appetite for, or aversion to, risk.
- **Leverage** – the use of leverage, or borrowing, is often a feature of absolute return funds. Derivatives allow investors to gain access to the performance of an asset at a much lower cost than buying the real asset. It makes sense for funds that generate returns through relative value trades to allow a certain amount of leverage when the risk of individual positions is relatively small. For this reason, leverage is most frequently employed in funds that tend to match long and short positions, such as equity market neutral funds.

3.25 Hedge Funds

Hedge funds are pooled investments, whereby a number of investors entrust their money to a fund manager who invests in various traded securities. The aim of the hedge manager is to seek to provide positive absolute returns (as discussed in the preceding section) regardless of overall market movements. They will use one or more alternative investment strategies, including:

- hedging against market downturns
- investing in asset classes such as currencies or securities that are traded below their true value
- using return-enhancing tools such as gearing, derivatives and arbitrage.

The funds aim for an absolute return with limited volatility and this can result in their having limited or even negative correlation to the markets in which they operate. As a consequence, even when the markets are falling, hedge funds can and do achieve positive returns. However, the opposite can also be true.

There are four broad categories of hedge fund strategy:

Long/short funds – these funds invest in equities and/or bonds, combining long investments with short sales of individual securities and derivatives to reduce market exposure.

Relative value funds – in these funds managers rely on arbitrage to produce returns, i.e. by identifying and exploiting pricing anomalies between similar investments or combinations of investments.

Event driven funds – these use the price movements arising from anticipated corporate events to achieve their returns.

Trading strategies – these trade in currencies, bonds, equities and/or commodities and may use the same long/short approach as equity hedge funds.

Hedge funds were traditionally limited to institutional investors and very wealthy individuals, but the availability of funds of hedge funds has opened the market to retail investors.

3.26 Multi Manager Funds

There are two distinct approaches to multi manager funds:

- Manager of managers (MoM): MoM refers to the appointment of a few select managers, who are then given specific mandates to manage the investment in a single fund. The role of the MoM is to select the specialist managers, to monitor their performance and to alter the composition of the management team to adapt to market conditions or fund performance.
- Fund of funds (FoF): the FoF describes the process whereby a manager builds up a portfolio that invests in funds that are run by a number of other managers. The fund of funds itself is generally structured as an ICVC or as an investment trust.

What Do Multi Manager Funds Offer?

There are three distinctive features of multi manager funds:

Fund or Manager Selection Expertise

A key attraction of multi manager funds is the expertise that they bring to manager selection. For a fund of funds, the multi manager selection process deploys a number of analytical tools to narrow down the fund universe to a more manageable level. The multi manager is likely to consider a rigorous interview process with each of the fund managers that fit the investment criteria and these meetings will often reveal a good deal more than quantitative analysis

Importantly, this is also an ongoing process, as many factors can change in the management of a mutual fund, of which a direct investor may not be aware. Meanwhile, some fund managers perform well in certain investment backdrops but not others leading to periods of underperformance. The fund of funds manager can position himself for changing market dynamics by altering his portfolio accordingly.

Diversification

Investors in a multi manager fund also benefit from increased diversification. Traditional UTs provide an extra layer of diversification compared to investing directly in a few individual stocks. Multi manager takes this process a step further by creating blends of best of breed fund managers. A selection of managers with different investment approaches can reduce the risk in a portfolio without eroding the alpha they provide. Alpha is the standard measure of a fund manager's ability to add value.

The diversification aspect of a multi manager strategy and the manager's ability to tilt he fund towards certain investment styles is of even greater importance in multi region and/or multi asset class portfolios. Here the manager can reduce exposure to asset classes or regions of the world which have poor prospects and skew the fund towards areas with better fundamentals.

Access

Another attraction of the multi manager approach is that it allows smaller investors access to certain funds and investment expertise that would not normally be available. This is due to the minimum amounts of investment, which can be quite substantial, required by some investment vehicles or simply because they are not widely known in the wider market.

The Case Against Multi Manager Funds

The main criticism levelled at multi manager funds is that they have higher charges. Single manager mutual funds charge fees to investors and so do multi managers' funds. Therefore, it would follow that investing in a multi manager fund results in two layers of charges. This is largely true but, given that one of the benefits of investing in a multi manager fund is economies of scale, such funds are able to negotiate very attractive rates, leading some to have TERs (total expense ratios) similar to standard mutual funds.

3.27 Tax Treatment of the Investor

The tax position for OEICs and UTs can be summarised as follows:

- no CGT on gains within pooled vehicle
- realised gains for individual investors on disposal of both types of fund are subject to the normal CGT rules viz. 18% where total taxable gains plus income are less than the upper limit of the income tax basic rate band or 28% above that limit. CGT will not apply if the fund is held under an ISA wrapper
- excepting certain cash and fixed interest OEICs/UTs, the fund itself is subject to a special 20% rate of Corporation Tax on any income it receives
- UK dividends are paid with no additional tax liability but tax on overseas dividends will normally be reduced by foreign withholding tax
- the investor receives any dividends from the OEIC/UT and is taxed in the same way as if the pooled vehicle holding were a direct equity investment. The £5,000 Dividend Allowance applies from April 2016 (£2,000 from April 2018) and OEIC/UT income is treated in the same way as other dividends
- if income is reinvested either within the OEIC/UT (i.e. where accumulation units apply or further units are purchased) a potential income tax liability still arises for the higher rate taxpaying investor.

Investors may be liable to pay Capital Gains Tax on any profits they make when they sell their investment trust shares. CGT would be payable if their gains on all disposals, after the deduction of losses, exceed their annual CGT allowance.

3.28 Offshore Funds

Offshore funds are OEICs, structured either as investment companies or UTs, which are established outside the UK – usually in low tax areas. For an individual who is UK resident and UK domiciled there are very few tax benefits in using these funds. For UK expatriates who are classed as non-residents and for non-UK domiciled UK resident investors there may be both Income Tax and CGT advantages and, for the non-domiciled investor, IHT benefits.

While there are many offshore funds, for practical purposes, emanating from FCA regulations, not all funds can be marketed in the UK. Those that can are generally those funds established as UCITs in other EU countries or are offered by providers in the Isle of Man or the Channel Islands. Many of the most popular funds have an OEIC structure and are managed by the offshore arm of UK investment groups.

Since offshore funds are typically set up as OEICS they often look like UK OEICs and may well be managed by an offshore branch of a UK provider. But tax treatment depends on their status.

Offshore funds can apply for Reporting Status, a tax regime introduced by the Offshore Funds (Tax) Regulations 2009 (replacing the earlier 1984 regime). If a fund has reporting status this means that while it does not need to distribute all its income, it will report its income to HMRC.This means that dividends may be paid gross (and the investor will need to declare this income if he is UK resident), while any CGT arising on a sale enjoys the annual exemption limit where applicable. This can give tax advantages if sales are timed to suit the investor's circumstances e.g. not resident at the time of sale or able to benefit from the annual allowance. However if an offshore fund holds more than 60% of its assets in interest bearing securities, any distribution will be treated as a payment of interest to the UK investor. This means that no tax credit will be available and the tax rates applying will be those applying to interest (20%, 40% and 45%). It is not necessary for income to be physically distributed, as the reporting regime allows for deemed distributions (or a combination of actual and deemed). A UK investor will then be taxed on their share of the income of the fund, including deemed.

If an offshore fund is non-reporting, it can accumulate income i.e. roll up income and consequently not pay dividends. Then the gain on disposals (death being regarded as a disposal) is calculated under CGT rules in the year

of disposal except that the annual CGT exemption cannot be claimed. Therefore the UK resident will see the gain taxed at the basic, higher or additional rate which applies to him, even though the gain may consist wholly or largely of dividends or reinvested savings income. Roll-up funds are useful in that they can be used to shelter accumulated income, which may enable the investor to realise profits when their tax rate has dropped or they have become non-UK resident. For non UK residents, while the income and gains will be free of UK tax they may need to pay tax in their country of residence. Care is need in this complex area: HRMC's Offshore Funds Manual states for non-reporting funds that "UK investors in non-reporting funds remain chargeable to Income Tax (or Corporation Tax if not an individual) on any distributions the fund actually makes to them. Alternatively, if the fund is transparent for income purposes then the investor will be chargeable to tax on income arising on the underlying investments".

For non-domiciled investors IHT liability is based only on their UK assets, so offshore funds will escape the UK IHT net.

While the use of offshore investments is legitimate, the adviser will need to take particular care to ensure that tax regulations are not overlooked. Increasingly, particularly as Pension Scams proliferate, offshore investments are being seen by the Press as tax evasion. While they are not vehicles for tax evasion per se, they could be if misused: but then so too could a pension scheme if someone knowingly tried to exceed his Lifetime Allowance. Offshore investments are legitimate ways to mitigate tax: just as contributions to pension schemes are a legal way to avoid unnecessary tax.

But offshore arrangements are becoming socially unacceptable in the eyes of some Press commentators. On 5 November 2017, the Guardian let off its own fireworks with the following article (extract):

> "Millions of pounds from the Queen's private estate has been invested in a Cayman Islands fund as part of an offshore portfolio that has never before been disclosed, according to documents revealed in an investigation into offshore tax havens. Files from a substantial leak show for the first time how the Queen, through the Duchy of Lancaster, has held and still holds investments via funds that have put money into an array of businesses, including the off-license chain Threshers, and the retailer BrightHouse, which has been criticised for exploiting thousands of poor families and vulnerable people."

3.2.9 Cost and Charges

Individual Fund Charges vary enormously. We consider their impact in the Retail Advice and Regulation unit, where we look at the suitability of products for meeting a client's needs.

3.3 OTHER INDIRECT INVESTMENTS

Note that tax efficient savings vehicles are considered in the next section.

3.3.1 Life Assurance Based Investments

Certain types of life insurance policies can be used as investments. Whether a life insurance policy is a qualifying or non-qualifying will determine how it is treated for tax purposes.

Regular Premium Policies

Most monthly or annual premium investment policies, e.g. regular premium endowments, are classed as "qualifying policies". The investor is not liable to Income Tax or Capital Gains Tax on the proceeds of the policy when it matures. A qualifying policy, however, becomes a non-qualifying policy if it is cashed in or the investor stops paying the premiums either before 10 years have passed or before the contract is three-quarters of the way through its term (whichever comes first). If the policy was taken out on or after 21 March 2012, or taken out before that date and varied afterwards, the premiums payable in any 12-month period by any beneficiary for all such policies must be less than £3,600 per year.

Single Premium Policies

Single premium bonds, sometimes referred to as insurance company investment bonds, are non-qualifying life assurance policies, generally written on a whole of life basis. The true life assurance element is minimal generally a return only of the investment made with perhaps the addition of a nominal 1% of that investment on death.Their main advantage is that they can provide good tax planning opportunities for higher rate taxpayers though they have also been used in the past to access a wider range of investment funds. This investment advantage is much less significant than it was, say, two or three decades ago given the significantly increased use over that period of pooled investments like OEICs and UTs.The tax advantages stem from the fact that the underlying investments can grow within an insurance company's funds taxed at no more than 20% (the actual rate depends on realised gains on the insurance company's onshore investments and RPI-indexation remains available – a complex actuarial calculation). Any higher rate tax payer would perhaps be paying significantly more tax than that on dividend income and in CGT. So investment in a life assurance single premium bond gives long term tax advantages which could outweigh the probable extra administration charges emanating from a life assurance policy.

A further advantage of single premium bonds is that HMRC permit withdrawals of capital to be made each year at 5% of the original investment. This annual withdrawal allowance is cumulative: any unused part can be carried forward to future years, subject to the total cumulative 5% allowance amount not exceeding 100% of the amount paid into the bond. This can be a tax-free income; so a higher rate tax payer (or any other individual for that matter) investing £100,000 in a bond, which increases in value in, say, an equity investment medium to £130,000 in two years, can take out at the end of the two year period £10,000 tax-free (or £5,000 in each of two years). No tax is payable by the bond-holder in these scenarios since any tax due has already been met by the insurance company. Strictly the withdrawals are not so much tax-free, but tax-deferred: once the 5% annual withdrawals have been used up over a 20-year period (or longer if the full 5% is not taken each year) then tax does became payable. However, if the higher rate taxpayer has become a basic rate taxpayer at the end of the 20-year period (or whenever the bond is encashed) or if the additional rate taxpayer is in a lower tax bracket, then effectively additional tax has been avoided or at least reduced even though income may well have been taken exceeding the original investment.

When the bond is eventually enchased any gain could potentially push the bondholder into the higher rate tax bracket, even if he is normally a basic rate taxpayer. But HMRC permits 'top-slicing relief': see Example below. Top-slicing works in this way: the difference between the amount invested and the final value of the bond, including any withdrawals, is divided by the number of years the bond has been held. That gives the average annual gain.That average gain is then added to other income in the year of encashment and if the total still falls within the basic rate tax band, then no further tax is payable. But if it falls into the higher or additional rate tax band, higher or additional rate tax is due on the part of the gain which that falls within the higher tax band, multiplied by the number of years the bond has been held. Encashment of bonds can be a complex area requiring advice. Individuals whose income is near a higher tax band need to consider their position carefully. If they are married they may be able to give the bond to a spouse if that spouse is on a significantly lower tax rate and allow the spouse to encash. Other adjustments should be considered to taxable income. Or encashment should be delayed. Investors and their advisers need also to be mindful of the possible loss of the loss of Personal Allowance for individuals earning close to £100,000: £1 of Personal Allowance for every £2 of taxable income exceeding £100,000. Remember though that the 5% withdrawals are not classed as income but as return of capital: annual 5% withdrawals themselves would not prejudice entitlement to an individual's Personal Allowance.

The following Example illustrates the way top-slicing works:

Tim, for many years a Higher Rate Tax payer, now has taxable pension income in 2019/20 of £32,500, **after** deducting his Personal Allowance. During the year, he surrenders a single premium investment bond which has been in force for 20 years.The surrender value amounts to £65,400 and whilst the bond was in force, Tim withdrew £1,500 for each of its 20 years, being 5% of the initial investment i.e. £30,000 in aggregate over 20-year period.

Calculate the top sliced gain, the amount of the gain which will be liable for Higher Rate Tax and HRT payable.

Method: *(Proceeds + Withdrawals) less (Initial Investment) = Gain*
(£65,400 + £30,000) less (£30,000) = £65,400.
(Top-sliced Gain + Gain/number of years in force)
Top sliced gain £65,400/20 = £3,270.
Taxable income + top sliced gain (£32,500 + £3,270) = £35,770.
(adjust for Basic Rate relief)
£35,770 less basic rate threshold (£34,500) = £1,270.
£1,270/£3,270 x £65,400 = £25,400 (*amount on which HRT is payable*)

Higher Rate Tax: £25,400 x 20% (40% less Basic Rate Tax @ 20%) = £5,080.

Note that the chargeable gain is subject to HRT to the extent that the Basic Rate threshold is exceeded but only to that extent. If Tim's pension had been £30,500 rather than £32,500, then the Taxable Income after top-slicing would have been (£30,500 + £3,270) = £33,770. No HRT would have been due. Basic Rate Tax is already deemed to have been paid on the underlying investment while it was in force. Had Tim's pension been £34,500 then his Taxable Income would have been (£34,500 + £3,270) = £37,770. Full HRT would have been due and no top-slicing relief would have been available (but again Basic Rate Tax liability already met).

Single premium bonds can be used by investors with substantial portfolios: switching of funds does not use up CGT annual allowances and in consequence may give more flexibility in investment switching.

Single premium investment bonds are classed as non-qualifying policies and attract income tax when they are cashed in if the investor has made a gain.

With Profit Policies

With profits funds are traditional type of insurance policy investments which seek to provide a good level of return from a mixed pool of assets, but without the investor being exposed to the volatility associated with direct investment. With profits policies aim to smooth the returns over the life of the policy by keeping back a reserve in good years and providing a bonus in weaker years. They are designed to provide a steady growth. However over the last two decades or so, they have fallen out of favour as returns from them have tended to be limited and not transparent (returns and charges are both determined internally by the insurance company Actuary).

A typical with profits fund operates as follows:

- Contributions, less expenses, paid by all with profits investors are accumulated in a single investment fund.
- The fund is managed on a basis common to all investors.
- The asset mix of the with profits fund will be determined by the views of the investment manager and will vary over time. A proportion of the assets will generally be invested in Gilts (Government bonds) in order to match any guarantees given.

- The returns achieved by the fund will be distributed to investors by way of bonuses. These have the effect of smoothing out the extremes of performance of the underlying assets. The bonuses declared every year, often known as reversionary or regular bonuses, have the effect of increasing the guaranteed amount within the policy and are underwritten by the insurance company.These are designed to provide steady growth in the fund over a period of time.

There are a number of methods of transferring value to individual investors. In principle, they all increase the value of the with profits fund unit by any the addition of guaranteed bonus promised by the contract or as bonuses as declared by the Actuary to the provider offering the with profits contract.

Bonuses are normally declared every year and are often known as reversionary or regular bonuses; they are called interim bonuses when a claim occurs part way through a policy bonus year. These annual bonuses increase the guaranteed amount within the policy and are underwritten by the insurance company. These are designed to provide steady growth in the fund over a period of time. A final share of profits or terminal bonus is usually added when benefits are due to be paid under the contract. The amount of terminal bonus can be varied by the provider at any time and is not guaranteed. The Actuary determines the level of final bonus in line with the historical investment performance of the underlying investments, within the insurer's with profits fund, and according to his own professional opinion of what share of that performance is attributable to the specific class of with profits investment now maturing. For example, the Actuary may decide in a particular bonus declaration year that the terminal bonus should be 110% for all with profits contracts which started 35 years ago and which are maturing now.A terminal bonus of 90% may be considered more appropriate for those started 30 years ago, while the same Actuary may decide that a policy which has only been sharing profits for five years will not be entitled to any terminal bonus. The following year that same Actuary might declare different levels of terminal bonus which he feels more suited to investment conditions up to that new declaration date.

In setting rates of reversionary and terminal bonuses, the Actuary has to strike a balance between investing in assets with the potential for higher returns and achieving the promised level of guarantees. If a high proportion of the relevant assets are required to provide the guaranteed levels of benefits, this could lower investment returns and consequently lower payouts to policyholders.

Opponents of with profits investments argue that this approach provides a costly form of smoothing whereby the guarantees only apply automatically at the end of the contract. If the investment is withdrawn from the fund before that date, the price of the units to be sold may be different from the market value of the investor's share of the investments in the fund at that time. If the price is higher than the share of the investments, a market value reduction is likely to be applied. This is so the investor does not take more than his or her fair share of the fund and penalise those that remain. The reduction is likely to be applied following a large or sustained fall in stock markets or after a period where investment returns are regularly below the level the insurer anticipated.

The Financial Conduct Authority announced in June 2017 that it is to launch a probe into with-profits insurance policies, focusing on whether customers are treated fairly. It is expected that it will deliver its report in 2018.

Purchased Life Annuities

Purchased Life Annuities are another traditional type of insurance policy. They can be written on a fixed term, or "term certain" basis , for example to provide ten years' income and some decades ago were quite frequently met with in this format in conjunction with and as a means of funding ten-year With profits endowment contracts . But tax changes, the removal of Life Assurance Premium Relief and the rise of ISAs have largely seen such fixed term contracts reduce in popularity. Nevertheless there could still be situations, school fees payment for example, where fixed term Purchased Life Annuities might be favoured for the consistent income which they could produce (funding from a portfolio of equity-based assets would not be easy to predict).

A Purchased Life Annuity (PLA) can also be used where the purchase sum i.e. initial capital funds a lifetime annuity on a single life basis or a joint life basis, and level in payment or increasing at a pre-determined rate for each year of payment

Because a PLA is generally funded from taxed income or assets, HMRC accept that part of a PLA represents a return of capital. A Compulsory Purchase Annuity (CPA) by way of contrast normally comes from a tax-advantaged pensions scheme and all the CPA income is then taxed. With a PLA the portion of income which is regarded as capital is treated by HMRC as capital content (or exempt amount) and is not taxed.The balance of the PLA income is subject to tax.

3.3.2 Exchange Traded Funds and Exchange Traded Commodities

Exchange Traded Funds (ETFs) are index-tracking funds that are listed and traded on major stock markets around the world in the same way as shares in publicly quoted companies, which are designed to match the return on the index they are tracking. They are similar to index-tracking pooled funds but they are traded like a single share through stockbrokers and their prices are updated throughout the day. They were designed to combine the advantages of share trading flexibility with the risk-spreading advantages of pooled investment vehicles.

ETF transactions are subject to the same fees as share transactions, i.e. brokers' commissions, but there is no stamp duty to pay on purchases. Typically management fees are less than 0.5%.

An investor will be subject to income tax on dividend payments and CGT on any gains arising on disposal in the same way as equities.

Exchange Traded Commodities (ETCs) work in the same way as ETFs, but track the performance of an underlying commodity or basket of commodities, such as metals, natural energy resources and agricultural produce or livestock.

Exchange Traded Notes are unsecured bonds issued typically by a bank.They also track a given index but involve additional risks since they are derivative based.

3.3.3 Derivatives

Derivatives are a type of financial instrument that derive their value from the price of an underlying asset, such as an interest rate, equity, commodity or currency. Instead of having to buy or sell the underlying asset, a fund manager can buy or sell a derivative linked to the underlying asset, often at a lower cost, and still take advantage of movements in the underlying asset. Derivatives are not only linked to single assets, but may also provide exposure to a market or sector. Many different types of derivatives exist, some of which are highlighted below.

Their purpose may be to protect a trader from an unexpected and undesirable price movement in the commodity with which he is dealing. Or it may be an investment. The two different parties involved here may both be able to match their own needs in a contract between them. A farmer may require a certain price for his wheat to cover costs and provide him with personal income. He will probably be very content to know that he will get a known amount for his crop which he can then concentrate on producing. A speculative investor may be very happy to offer that known amount to the farmer in the expectation that he will be able to sell that wheat for a higher price on the market. Two very different results will be achieved: the cautious famer will have been protected by the contract (the risk of his not covering his costs would have been removed) while the speculative investor may make a significant profit for the risk he is taking.

Futures and Forwards

Futures are contracts whereby a buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today. Futures are standardised products, traded on an exchange.

Forwards are contracts similar to futures, but customisable and traded "over the counter" (OTC) i.e. through private agreements rather than via an exchange.

Options

Options are a type of derivative that gives the buyer the right, but not the obligation, to buy (a "call" option) or sell (a "put" option) an underlying asset at an agreed price on a specified future date. Note that futures and forwards are fixed contracts which will ultimately result in a trade on the contact terms. Options do not necessarily result in a trade being completed. However the holder of the option will have paid an agreed fee for the right to exercise the option, or not.

Swaps

Swaps are contractual agreements where two parties agree to exchange (swap) either single payments or a series of payments in the future. While some swaps are highly complex, the vast majority of contracts involve the swap of a fixed series of payments for a floating series of payments. Swap contracts can be tailor made to each investor's specific requirements. They are not traded on an exchange, but OTC i.e. through private agreements. Financial organisations, such as banks and other money market institutions, are the main operators in the swaps market.

The following types of swap are widely used:

- Interest Rate Swaps – Counterparties exchange two future streams of interest payments, applied to a notional principal amount. In its most common form, a fixed rate of interest is exchanged for a floating or variable rate of interest, usually measured by an index such as LIBOR.
- Index Swaps – This type of swap involves the exchange of one index return for another index return or for a floating interest rate. The buyer pays the return on a money market deposit in exchange for the total return on an index, such as the FTSE 100.
- Currency Swaps – Counterparties exchange a pre-agreed amount of foreign currency now and re-exchange it at a certain specified date in the future.
- Credit Default Swaps (CDS) – A type of swap whereby one party buys protection ("insurance") from another party against the default of a third party, usually a corporate bond issuer(s).The seller of protection is in a very similar position to an investor in the underlying bond – they will receive regular interest payments but will be left with a bond which could be worth substantially less than face value if the corporate issuer defaults.

Collateralised Debt Obligations

This type of contract was initially conceived as a structured asset-backed security for the corporate debt markets (we considered subordinated debt in the Private Equity section 2.11 above). Gradually they evolved to serve the needs of the mortgage market.The structure is designed to meet the promise to pay investors in an agreed order. Incoming cash flow is use to pay its "senior" investors first. More junior investors, while receiving a higher level of promised return need to wait until the "senior" investors have been paid.The more junior investors may make a much better return. Or they may lose out; as happened in the American sub-prime mortgage crisis which triggered the world-wide Stock market collapses in 2008/9.

A Mortgage backed security is a type of Collateralised Debt Obligation which is backed by residential or commercial mortgages.

Contracts for Difference

A contract for difference (or CFD) is a contract between two parties, whereby the seller agrees to pay the buyer the difference between the value of an asset now and its value at the contract expiry. This enables fund managers to benefit from changes in the price of an asset without actually owning it.

Taxation of Derivatives

Profits from both futures and options are usually chargeable to Capital Gains Tax. For individuals, there is no CGT on gains or allowable losses on futures or options based on Gilts or qualifying corporate bonds.

3.4 TAX EFFICIENT SAVINGS VEHICLES

3.4.1 Individual Savings Accounts

Individual savings accounts (ISAs) are tax favoured savings and investment accounts, introduced in April 1999 and building on the earlier Personal Equity Plans. They can be used to save cash, to invest in stocks and shares or to invest in the new Innovative Finance ISA.

The maximum an individual could put in to an ISA was £11,880 at the start of the 2014/15 tax year, up to £5,940 of which could be saved in cash. Contributions were permitted to only one cash ISA and/or one stocks and shares ISA during the tax year. Following the 2014 Budget, the ISA rules were relaxed so that from 1 July 2014 the maximum allowance was increased to £15,000 and it further increased to £15,240 from 6 April 2015, remaining at £15,240 for 2016/17. From 6 April 2017, the ISA limit became £20,000.

Furthermore the division between stocks and shares ISAs and cash ISAs has been removed. Investors are now able to contribute to cash ISAs or stocks and shares ISAs or the new Innovative Finance ISA and they can transfer between them as often as they wish. Called New ISAs (NISAs) or SuperISAs in mid-2014, the name has now settled back down to ISAs, which now have welcome added flexibility. The Budget in March 2015 also added further flexibility by permitting the withdrawal of monies in a tax year and permitting its replacement during the same tax year without using up any remaining ISA allowance.

When the maximum investment in a tax year has been reached, the investment of additional sums is not allowed.

In the 2014 Autumn Statement, the Chancellor announced that the law would be changed so that the spouse or civil partner of a saver who died on or after 3 December 2014 would be able to benefit from an additional ISA allowance equal to the value of the deceased saver's ISA holdings on their date of death. From 6 April 2015, the surviving spouse or civil partner has this Additional Permitted Subscription as well as their own ISA subscription limit in the year of the partner's death.

Investors do not pay any tax on the interest or dividends received from an ISA and any profits from investments are free of CGT. Losses on ISA investments cannot be used to reduce CGT on profits from investments outside the ISA.

To pay into an ISA an investor must be:

- a UK resident or a Crown employee, such as a diplomat or member of the armed forces, who is working overseas but paid by the Government, or the husband, wife or civil partner of a Crown employee
- 16 or over for a cash ISA
- 18 or over for a stocks and shares ISA.

It is not possible to hold an ISA with or on behalf of someone else.

The introduction of the Personal Savings Allowance from April 2016 (see section 1.6.1 of Part 2 of this study manual) and the intended change which will allow banks and building societies to pay interest gross, may, notwithstanding the above improvements to ISA terms and flexibility, mean that the use of Cash ISAs will significantly reduce.

UTs and OEICs can be held in ISAs. Where these are held in an ISA they benefit from the exemption from CGT on any realised gains. The full ISA allowance can be invested in qualifying UTs and OEICs either as a lump sum or regular savings.

Innovative Finance ISAs

In 2014, the Government announced that 'peer to peer' loans would become ISA qualifying investments and following a consultation, it was confirmed at Summer Budget 2015 that this would be permitted through a new type of ISA, the Innovative Finance ISA, from April 2016. The stated policy objective was to increase the choice and flexibility available to ISA investors, encourage the growth of peer to peer lending and improve competition in the banking sector by diversifying the available sources of finance.

In order to offer the Innovative Finance ISA, providers need to apply for regulatory permissions from the FCA. Delays in obtaining the required approval meant that few IFISAs were available during 2016/17, although two dozen providers are now active in the market. These providers tend not to be well-known – yet –and it remains to be seen whether the projected returns, often in excess of 10%, will be achieved over the next few years without significant capital erosion. Advisers using these investments need to ensure that their clients fully accept the risks involved. (See also above section 2.11 on Private Equity.)

3.4.2 Help-to-Buy and Lifetime ISAs

Unlike pension schemes, ordinary ISAs which are available to adults do not benefit from additional Government input in the form of tax relief on contributions or other Government input into personal pension through grossing-up to generate basic tax relief. ISA tax-efficiency has traditionally come from tax-relived interest and growth; a limited benefit when compared with pensions. This started to change in 2015.

Help-to-Buy ISA. The March 2015 Budget introduced from 1 December 2015 the Help-to-Buy ISA under which the Government contributes £50 for every £200 that first-time buyers save for a house deposit, up to a maximum of £3,000: i.e. maximum a saver can put in is £12,000 (£24,000 for a couple, as the limit is per person not per home). The Government's contribution of 25% of the amount saved will go directly to the lender when the first home is purchased. Savers will not be able to put their money in a stocks and shares ISA. An initial contribution of £1,200 (£1,000 extra) is possible followed by the £200 monthly contributions. If a month is missed it cannot be made up. There is a limit on the value of the first home which may be purchased: £250,000 (£450,000 in London). The Help to Buy ISA will only run for 4 years until 30 November 2019. It will not be available for new savers after that date although those who had already opened a Help to Buy ISA will be able to continue saving into that account. There is a further 10 year time limit for claiming any bonus, which will not be available after December 2030. Those who have opened a Help to Buy ISA are able to transfer funds into a Lifetime ISA (see below) during 2017/18 and would then instead be subject to the terms of the LISA.

Lifetime ISAs. This feature, the direct input of Government contributions, was extended with Lifetime ISAs as another way for the younger person to save on a long-term basis. Announced in the 2016 Budget, the new Lifetime ISA allows investors to save up to £4,000 each year, and receive a Government bonus of 25%. A Lifetime ISA account can be opened between the ages of 18 and 40, and any savings put into it before an investor's 50th birthday will receive the added 25% bonus from the Government. Some or all the money can be used to buy a first home, or kept it until age 60. Accounts are limited to one per person rather than one per home and the bonus can be used towards a deposit on a first home worth up to £450,000 across the country.

Investors with a Help to Buy: ISA can transfer those savings into the Lifetime ISA in 2017/18, or continue saving into both – but will only be able to use the bonus from one to buy a home.

Investors can withdraw the money at any time before they turn 60, but will lose the government bonus (and any interest or growth on this) and have to pay a 5% charge on the original investment. Effectively this means a penalty of at least 6.25%: if a person saved £100 which receives a £25 Government bonus, withdrawing involves a penalty of 25% on the whole £125 i.e. £31.25 (ignoring interest), leaving £93.75. An investor who is terminally ill with less than 12 months to live, will be able to withdraw all of the funds (including the bonus), regardless of age and without the application of the above penalty.

3.4.3 Junior ISAs

Junior ISAs are ISAs especially for children. From 1 November 2011 they were made available to any child under 18, living in the UK, who did not have a Child Trust Fund (CTF) account. Up to £3,840, in cash or stocks and shares in any proportions, could be saved in the tax year starting 2014/15 into a Junior ISA with no tax paid on the interest or dividends. From 1 July 2014 the maximum increased to £4,000, or £15,000 for 16 to 18 year-olds (though contributions above £4,000 needed to go into a cash ISA). These maxima have since been increased and from April 2017 are now £4,128 and £20,000. A child can have a Junior ISA if he or she:

- is under 18
- lives in the UK
- is not entitled to a Child Trust Fund (CTF) account.

The money in the account belongs to the child and cannot be taken out until they are 18. This does not preclude a 16 or 17 year-old from controlling his Junior ISA account(s). If not encashed at 18, the Junior ISA will become an adult ISA without needing to meet the then ISA limits.

Anyone can pay into a Junior ISA for the child's benefit, so they can be used by grandparents wishing to provide birthday or Christmas presents or help build up a fund for the child to have at 18 to, say, use to fund further education.

3.4.4 Child Trust Fund

A child born between 1 September 2002 and 2 January 2011 could be entitled to a CTF account.The scheme was launched in January 2005 fulfilling a promise made in the Labour Party's 2001 Manifesto.A child is entitled to an account if all of the following apply:

- he or she was born between 1 September 2002 and 2 January 2011
- Child Benefit was received for that child for at least one day before 4 January 2011
- the child lives in the UK
- the child is not subject to any immigration restriction (this could apply if they were born outside of the European Union to non-British parents).

For each child that is entitled to a CTF account, HMRC will usually send a voucher to be used to open the account in the child's name. The voucher could be worth £50 or £250 depending on when your child was born and when they became entitled to an account. The money in the CTF account belongs to the child but cannot be taken out until they are 18.There is no tax to pay on the CTF income or any gains it makes.

Contributions of up to £4,128 from April 2017 may continue to existing CTFs but any contribution will preclude opening a Junior ISA. In December 2013, the Government announced that from April 2015, CTFs could be converted to Junior ISAs which opens up a greater contract choice to CTF holders. Importantly, because CTFs are a closed book as far as deposit takers are concerned, it is likely that more competitive rates will be available on Junior ISAs

3.4.5 National Savings & Investments (NS&I)

NS&I is an Executive Agency of the Chancellor of the Exchequer. HM Treasury uses the money invested in NS&I to manage the national debt cost-effectively, contributing to the Government's financing needs. NS&I's remit is responsibility for providing cost-effective financing to the Government by issuing and selling retail savings and investment products to the public. It is one of the largest savings organisations in the UK, with over 25 million customers and more than £147 billion invested [Source: National Savings and Investments Annual Report and Accounts and Product Accounts 2016–17]. It offers a secure way of saving and investing as it is backed by HM Treasury.

One of its best known products is Premium Bonds, where the maximum investment is now £50,000. Any prizes won via Premium Bonds are tax-free.

NS&I offers a range of other savings and investments including a range of bonds, e.g. growth, income and equity.

This range includes some products that are tax-free. The tax-free savings and investment products currently include:

- Cash ISA – for savers aged 16 or over
- Fixed Interest and Index Linked Savings Certificates – for savers aged seven or over
- Children's Bonus Bonds – these can be invested for five years on behalf of children aged under 16.

The amount people can invest in any product is generally restricted: not a problem for most investors but it does mean that very wealthy investors may well find that NS&I products are of limited use.

Product availability is extended or even reduced from time to time. In line with its remit, this adjustment to product availability can be for political reasons, to meet the perceived needs of the UK economy or to help savers. For example, January 2015 saw the launch of the new 65+ Bonds available to persons over 65 for lump sum investments of £500 to £10,000, delivering gross interest of 2.80% p.a. for the one-year Bond (this competitive contract was not re-offered for January 2016: the replacement rate in an ordinary Guaranteed Growth Bond being 1.45%) and 4.00% p.a. for the three year Bond. At other times, to limit the inflow to Government coffers, certain products e.g. index-linked investments, may not be available.

3.4.6 Venture Capital Trusts

NB https://www.gov.uk/guidance/venture-capital-schemes-raise-money-by-offering-tax-reliefs-to-investors, 2017, states that there are four types of VCT. We consider these in this and the following three sections.

Venture Capital Trusts (VCTs), launched on 6 April 1995, are listed companies run by a fund manager. They are similar to investment trusts, but are designed to encourage individuals to invest indirectly in a range of small, higher-risk trading companies that are not listed on a stock exchange. Investors can subscribe for, or buy, shares in a VCT, which invests in trading companies, providing them with funds to help them develop and grow. VCTs allow investors to spread risk across a limited range of entrepreneurial companies. The 2014 Finance Act permitted VCTs to be held in the name of a nominee. VCTs realise their investments and make new ones from time to time.

Income Tax and CGT reliefs are only available to individuals aged 18 years or over and not to trustees, companies or others who invest in VCTs. The reliefs are as follows:

- Income Tax relief at the rate of 30% of the amount subscribed for shares issued in the tax year 2006-07 and onwards (for subscriptions for shares issued in previous tax years the rate was 40%). This relief is available for the tax year in which these "eligible shares" were issued, provided that the investor subscribed for the shares on his or her own behalf, the shares were issued to the investor;
- the investor holds them for at least five years (sale of shares before five years have expired means loss of the Income Tax relief). The 30% Income Tax relief is available to be set against any Income Tax liability that is due, whether at the lower, basic or higher rate;

- there is an annual limit for Income Tax relief in any tax year where an individual has shares in VCTs: up to a permitted maximum of £200,000 (it is expected that this will be doubled for knowledge intensive companies following the November 2017 Budget);
- exemption from Income Tax on dividends from ordinary shares in VCTs (dividend relief). NB This relief is not extend to EIS, SEIS and SITR schemes – we consider these other three versions of venture capital incentive schemes below;
- the investor will not have to pay CGT on any gain made when he disposes of VCT shares (this is called disposal relief). Losses on VCTs cannot be offset against CGT gains on other investments.

Two of the reliefs, dividend relief and CGT exemption, are available for both newly issued shares and second-hand shares acquired, for example, through the Stock Exchange. But Income Tax relief can be claimed only if subscribing for new shares.

VCTs must be approved by HMRC to enable investors to qualify for certain tax reliefs; the providers need to ensure that their schemes meet the detailed approval conditions. However this approval does not mean that the investment into the VCT is without risk. All VCT investments, given that the rationale for their existence is to support entrepreneurial undertakings, are highly risky. Indeed, in a consultation paper, Financing Growth in Innovative Firms, published in August 2017, HM Treasury expressed concern that "capital preservation" was central to the focus of too many VCTs: the November 2017 Budget announced that the next Finance Bill would include provisions to ensure that VCTs and EISs are "not used as a shelter for low risk capital preservation schemes".

If the fund manager fails, as opposed to the investment performing badly, then FSCS compensation may be available.

3.4.7 Enterprise Investment Schemes

The Enterprise Investment Scheme (EIS) is designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.

The tax reliefs [Source: gov.uk Helpsheets HS297 & HS341, 2017] available include Income Tax relief, CGT exemption, loss relief and CGT deferral relief. HMRC warn that both investors and companies should note that no relief will be given (or if it has been given, it will be withdrawn) if any scheme has as its main purpose, or one of its main purposes, the avoidance of tax. (The tax reliefs available under the EIS are of course not considered to be avoidance of tax.) The reliefs are as follows:

- Income Tax relief is available to individuals (only) who subscribe (although this can be through a nominee) for shares in an EIS. Before 6 April 2012, there had to be a minimum investment of £500 worth of shares in any one company in any one tax year. For shares issued on or before 5 April 2011 the relief was 20% of the cost of the shares, to be set against the individual's Income Tax liability for the tax year in which the investment was made. From 6 April 2011 relief was increased to 30% of the cost of the shares;
- the shares must be held for a certain period or Income Tax relief will be withdrawn. Generally, this is three years from the date the shares were issued. But if the qualifying trade started after the shares were issued, the period is three years from the date the trade actually started;
- from 6 April 2012, relief can be claimed up to a maximum of £1 million invested in such shares, giving a maximum income tax reduction in any one year of £300,000 (it is expected that this will be doubled for knowledge intensive companies following the November 2017 Budget);
- there is a "carry back" facility which allows all or part of the cost of shares acquired in one tax year, to be treated as though those shares had been acquired in the preceding tax year. Relief is then given against the income tax liability of that preceding year rather than against the tax year in which those shares were acquired.This is subject to the overriding limit for relief for each year;

- the investor will not have to pay CGT on any gain made when he disposes of EIS shares (this is called disposal relief);
- CGT deferral relief is available to individuals and trustees of certain trusts. The payment of tax on a previous capital gain can be deferred where the gain is invested in shares of an EIS qualifying company. The gain can arise from the disposal of any kind of asset, but the investment must be made within the period one year before or three years after the gain arose. There are no minimum or maximum amounts for deferral. And it does not matter whether the investor is connected with the company or not. Unconnected investors may claim both income tax and capital gains deferral relief. There is no minimum period for which the shares must be held; the deferred capital gain is brought back into charge whenever the shares are disposed of, or are deemed to have been disposed of under the EIS legislation.

Income Tax relief can only be claimed by individuals who are not "connected" with the company. A person can be connected in 2 ways:

- connection by financial interest in the company: if a person controls the company (and the holdings of business associates and relatives may be assessed in determining control) or holds more than 30% of the share capital or voting rights, that person is connected with the company. These conditions apply throughout the period beginning 2 years before the issue of the shares and ending 3 years after the issue (or 3 years after the commencement of the trade if that followed the share issue)
- connection by employment: if a person is a partner, director (excluding non-remunerated "Business Angel" directors) or an employee of the company, that person is connected. Eligibility for relief is also not available if an associate (see above) is so connected. This restriction applies not only at the time the shares were issued but to the 2 year period before the shares were issued and the 3 years after the issue (or the 3 years after the commencement of the trade if that followed the share issue).

If an individual received Income Tax relief (which has not subsequently been withdrawn) on the cost of the shares, and the shares are disposed of after they have been held for the period referred to above, any gain is free from CGT. However, if no claim to Income Tax relief is made, then any subsequent disposal of the shares will not qualify for exemption from CGT.

If the shares are disposed of at a loss, an individual can elect that the amount of the loss, less any income tax relief given, can be set against income of the year in which they were disposed of, or any income of the previous year, instead of being set off against any capital gains.

The company which issues the shares has to meet a number of rules (detailed in gov.uk guide, but not part of the PMI Syllabus) regarding:

- the kind of company it is
- the amount of money it can raise
- how and when that money must be employed for the purposes of the trade
- the trading activities carried on.

The company must satisfy HMRC that it meets these requirements and is therefore a qualifying company

3.4.8 Seed Enterprise Investment Scheme

The Seed Enterprise Investment Scheme (SEIS) is designed to help small, early-stage companies raise equity finance by offering tax reliefs to individual investors who purchase new shares in those companies. It complements the existing EIS, which offers tax reliefs to investors in higher-risk small companies. SEIS is intended to recognise the particular difficulties which very early stage companies face in attracting investment, by offering tax relief at a higher rate.

SEIS is applicable for shares issued on or after 6 April 2012.The rules were designed to mirror those of EIS as HMRC anticipates that companies will go on to use EIS after an initial investment under SEIS. SEIS applies to smaller companies, those with 25 or fewer employees and assets of up to £200,000, which are carrying on or preparing to carry on a new business.

The main tax saving features for an SEIS are:

- Income Tax relief worth 50% of the amount invested to individual investors with a stake of less than 30% in such companies, including directors who invest in their companies;
- shares must be held for a period of three years from the date of issue for relief to be retained;
- it applies to an annual amount of investment of £100,000 per investor;
- there is a "carry back" facility which allows all or part of the cost of shares acquired in one tax year, to be treated as though those shares had been acquired in the preceding tax year. Relief is then given against the income tax liability of that preceding year rather than against the tax year in which those shares were acquired.This is subject to the overriding limit for relief for each year;
- the investor will enjoy a partial exemption from CGT on gains on shares within the scope of the SEIS;
- CGT deferral relief is available to individuals and trustees of certain trusts.The payment of tax on a previous capital gain can be deferred where the gain is invested in shares of an SEIS qualifying company. The gain can arise from the disposal of any kind of asset, but the investment must be made within the period one year before or three years after the gain arose. There are no minimum or maximum amounts for deferral. And it does not matter whether the investor is connected with the company or not. Unconnected investors may claim both income tax and capital gains deferral relief. There is no minimum period for which the shares must be held; the deferred capital gain is brought back into charge whenever the shares are disposed of, or are deemed to have been disposed of under the SEIS legislation.

3.4.9 Social Investment Tax Relief

Social Investment Tax Relief (SITR) is designed to help social enterprises like a:

- registered charity
- community interest company
- community benefit society

which have a social impact. Social Impact Bonds (SIBs) are a commissioning tool that can enable organisations to deliver outcomes contracts and make SITR funding for services conditional on achieving results. The organisation may qualify if they have no more than £15 million in gross assets and fewer than 500 employees.

For the investor, the main tax saving features for an SITR are:

- Income Tax relief worth 30% of the amount invested to individual investors;
- shares must be held for a period of three years from the date of issue for relief to be retained;
- it applies to an annual amount of investment of £1,000,000 per investor;
- there is a "carry back" facility which allows all or part of the cost of shares acquired in one tax year, to be treated as though those shares had been acquired in the preceding tax year. Relief is then given against the income tax liability of that preceding year rather than against the tax year in which those shares were acquired.This is subject to the overriding limit for relief for each year;
- the investor will enjoy exemption from CGT on gains on shares within the scope of the SITR;
- CGT deferral relief is available to individuals and trustees of certain trusts. The payment of tax on a previous capital gain can be deferred where the gain is invested in shares of an SITR qualifying company. The gain can arise from the disposal of any kind of asset, but the investment must be made within the period one year before or three years after the gain arose. There are no minimum or maximum amounts for deferral. And it does not matter whether the investor is connected with the company or not. Unconnected investors may claim both income tax and capital gains deferral relief. There is no minimum period for which the shares must be held; the deferred capital gain is brought back into charge whenever the shares are disposed of, or are deemed to have been disposed of under the EIS legislation.

3.4.10 Defined Contribution Pension Arrangements

We considered the structure of DC arrangements in Part 1 of this study manual. In any DC pension arrangement (also known as a "money purchase" scheme) the benefits provided at retirement or on death will depend on the size of the investment fund that has built up. Consequently, investment considerations, as well as the appropriate structure, are a vital part of pension planning.

There is a range of investments available in which to invest under a DC arrangement and many of these will be pooled arrangements such as managed funds. In general the options can be broken down into four main asset classes:

- cash
- fixed interest securities
- equities, and
- property.

Unless an individual is a member of a small self-administered scheme or a self-invested personal pension, they are unlikely to select direct investment into an asset. Instead they are more likely to use collective investments such as OEICS, UTs, investment trusts, insurance company funds and with profits funds.

When an individual is deciding on suitable investments for their pension fund, their decisions will be influenced by their attitude to investment risk: we consider a client's own attitude to risk in the Retail Advice and Regulation module.

Each of the main asset classes has its own risk profile.

Cash is virtually risk free as the capital value remains unchanged, but there is still an element of risk as the value of the capital will be eroded over time by inflation and over the longer term the real returns are relatively low.

Fixed interest securities (or bonds) are also reasonably secure as they pay a regular fixed income that is not affected by changes in the interest rate and the capital value is returned on redemption. It should be remembered, however, that:

- bonds generally provide no protection against inflation
- both the income payments and capital value will be eroded over time by inflation unless they are a form of index linked stock
- the capital value can rise or fall in response to changes in market interest rates
- company bonds are riskier than Government bonds because there is the added risk of the company defaulting on interest and/or redemption payments.

Equities are riskier than bonds because the company is under no legal obligation to make dividend payments. Their capital values will fluctuate: and may fall dramatically. However, investors should consider that:

- historically long term investments in equities have outperformed other safer investments, such as cash and bonds
- there is potential for higher returns if individuals are willing to invest in the shares of smaller companies, but these shares are likely to be more volatile and the companies may fail
- individuals can spread the risk of equity investment by investing in collective investment funds, such as insurance company equity funds or equity UTs.

Property is an asset-backed investment and therefore has the potential for long-term protection against inflation. Over the longer term, however, property has been outperformed by equities, although in recent years this has not necessarily been the case. In most cases pension investments in property will be through a collective scheme as direct investment in property is a higher risk, especially if a tenant cannot be found, and also the costs associated with direct property purchase are high.

In general there is no liability to Income Tax on investments or deposits made to a registered pension scheme. Similarly, any gain accruing on a disposal of investments held by a registered pension scheme is not chargeable to CGT. An exception exists which removes tax advantages for any registered pension scheme that is an "investment regulated pension scheme", i.e. a self-invested personal pension arrangement or company pension scheme with 50 or fewer members which are able directly or indirectly to influence or advise on the scheme's investment. In these circumstances, tax charges arise on scheme members and scheme administrators when such a scheme acquires, holds, improves or disposes of taxable property unless the taxable property is acquired or held through a genuinely diverse commercial vehicle.

Please refer back to Part 1 of this study manual for details re contribution criteria and tax issues.

3.4.11 Friendly Society Policies

Friendly Societies are mutual self-help organisations often with a local client base. While Building Societies were growing in Industrial Revolution England in taking deposits, the Friendly Societies were leading the way with funeral and health policies. But the launch of the National Health Service in 1948 removed much of the traditional market for Friendly Societies.

Perhaps their most appealing aspect nowadays is that they can offer Tax Exempt Savings Plans, often still on a With Profits basis, where the maximum savings are £25 per month or £270 a year. The Government have not chosen to extend these limits in recent years. While Friendly Societies still can offer other contracts these are not frequently met with nowadays.

3.5 WRAPS AND OTHER PLATFORMS

A wrap account (or wrap service) is an arrangement that holds a range of investments, providing a single point of contact and management for investors and their agents. This is also known as an investment platform or financial platform service.

A wrap manager is usually a separate legal entity within a financial services or insurance group that offers to hold, manage and administer the whole or part of an individual's portfolio. The wrap account itself might typically be an interest-bearing bank account, with a set of sub-accounts. The wrap manager nominates a third-party discretionary investment manager and an execution-only broker. The discretionary investment manager generally offers, or is required by the wrap manager to offer, nominee account services. It may also offer custody services, or these may be provided by another entity.

The typical charging structures for wrap products are based on transaction charges, calculated by reference to the value of investments within the wrap account (taken as a strong indicator of activity going through the account), including dividends, interest, and principal amounts.

Wrap services or accounts usually enable investors, often with the advice of a financial adviser, to select from an extensive range of UK and offshore funds and assets – including UTs, OEICs, investment trusts, equities, cash, structured products, external fund managers and other investment products. The service can then be used to allocate these assets seamlessly to the most appropriate tax wrappers – including ISAs, CTFs and SIPPs.

The potential benefits to investors are:

- they only have one counterparty to deal with, which can save time in dealing with a diverse range of fund managers, financial institutions and other product providers
- investors can view their entire portfolio all in one place, enabling them to keep track of their current financial position on a daily basis, however complex their financial affairs
- they also receive a single consolidated annual tax statement, comprehensive six-monthly statements and documentation of all purchases, sales, deposits and withdrawals.

Nominee account

The simplest form of a wrap account is a "nominee account". Investors will typically make investments through a bank or building society account or via an IFA, stockbroker or other type of intermediary. Many of these operate nominee account arrangements. As far as the provider (e.g. the fund manager) is concerned, it receives a purchase instruction registered in the name of a nominee account. The fund manager does not need to have, and usually does not have, a relationship with the underlying investor. The intermediary will receive ongoing reporting/disclosures from the provider, which it will forward (appropriately customised/apportioned) to the underlying investors, of which there may be hundreds, or even thousands.

Fund supermarkets

Funds supermarkets provide a particular form of "nominee" wrap account. They provide access to a variety of collective funds managed by different fund managers. They are like supermarkets in that an investor is the shopper, the products are the funds, and the supermarket is the shop. They may offer advice or analytical decision/fund selection tools or simply provide "execution only" services.

Fund supermarkets allow investors to purchase fund shares/units from a variety of fund managers, usually at discounted prices. Such shares/units may be wrapped within a PEP or ISA, or held as standalone investments. The investor has a contractual relationship with the supermarket, and does not deal direct with the fund manager. Likewise, fund managers have no knowledge of individual investors – they simply see net, bulk orders from the supermarket's nominee account to sell or buy shares/units.

Typical services undertaken by the supermarket may include:

- fund transaction clearance and settlement
- receipt and payment of fund distributions
- maintenance of investors' fund information (share/unit balances, dividend and distribution information and transaction history)
- issue of all confirmations, statements, prospectuses and literature to investors
- sending of any tax vouchers to investors, including the amount of dividend and interest paid, and
- holding (by the supermarket or its nominee/custodian), of the shares/units subscribed for by investors, together with any reinvested dividends and distributions.

Investors usually pay no fee to the supermarket itself. Instead, the supermarket usually receives commission from the fund manager, which may be taken in the form of a rebate of the management fee. In this case, the "commission" represents a bulk discount for a large nominal investor, and, as such, is not a taxable supply. Increasingly, as competition in the supermarket space has built up, investors have often received discounts not only from initial purchases but also from existing investments probably in the form of loyalty bonuses. Because of increasing transparency required as a result of the FCA's Retail Distribution Review coupled with HMRC's wish to tax cash bonuses, the discount procedures are simplifying in that annual charges received by the management groups are falling and likewise discounts. At the same time transparency requires the fund manager and supermarket facilitator charges to be specified separately (i.e. unbundled). For supermarkets the new transparency rules for new sales come into effect on 1 January 2014. Underpinning this change is the FCA's determination to remove commission and bundled charges from the financial services marketplace. This was already in place from 1 January 2013 for new business placed through financial advisers: fees, not commission, needed to be transparently stated in the Terms of Business offered to clients.

Summary

Investors can make direct investments or can use investment products to invest indirectly. Direct investments are more likely to be suited to portfolios of at least £100,000. Where individuals are looking to invest smaller amounts indirect investments, i.e. collective or packaged investment products such as UTs, are likely to be more suitable. In this Chapter we first looked at the differences between direct and indirect investments. We then looked at indirect investment products including pooled investment vehicles, the derivatives market and tax efficient savings vehicles.

Self Test Questions

- What is the difference between direct and indirect investment?
- Why might a non-qualifying life assurance policy be advantageous for a higher rate tax payer?
- Distinguish between an Absolute Return and Relative Return fund.
- When is it possible to trade in ETFs: daily or some other frequency?

Apart from pay and pensions, health and risk benefits are some of the most important benefits required by an individual. People are becoming increasingly concerned that not only do they have the money to allow them to pay their bills and mortgages etc., but that they also have the means to ensure that if they become sick these outgoings are covered. They are also concerned with ensuring that their families are cared for in the event of their early death or permanent sickness. This Part is divided into two Chapters.

In Chapter 1, we look at the State benefits that are available and which provide financial protection. It is important that students are aware of and understand the different benefits that are provided by the State and how these interact with and impinge on benefits provided by private arrangements.

In Chapter 2, we look at the role of insurance in providing health and risk benefits and describe the characteristics of the products available. In this Chapter we discuss the various aspects of Private Medical Expenses Insurance, how this interacts with the NHS and the tax implications. We also look at Critical Illness schemes which bridge the gap between death benefits and Income Protection schemes and provide support to employees and their families where an individual has been diagnosed with a critical illness, such as a heart attack or cancer.

Before an adviser recommends any form of financial protection for an individual, which could include products discussed in this Part, he must take reasonable steps to find out sufficient information about the customer that will be relevant to the suitability of products which might be offered. These steps will also include assessing the benefits to which the client is entitled from State and employment. These "suitability" aspects are covered in detail in the Retail Advice and Regulation unit.

INTRODUCTION

Note: Where possible, monetary values quoted for State benefits are the relevant rates for the tax year 2019/20

The socio-political structure of developed economies inevitably involves State intervention. We have already considered taxes: they are part of what Governments take. But what do they give back? It has to be what the taxed citizens want, but what precisely and in what priority order? The answer is highly subjective and invariably in a state of flux. The interpretation by successive Governments of what a country's citizens want, or perhaps what the Governments think they need, is also in a state of flux. Consequently the provision of State benefits will constantly change.

In the last decade or so the cost of UK State benefits, in part due to the competitive World pressures the UK has needed to face, has become a major concern. As part of their response, the Coalition Government enacted, on 8 March 2012, the Welfare Reform Act which, according to its main architect, Iain Duncan Smith, the Secretary of State for Work and Pensions at the time, will restore the welfare system to one that is fair for society, simpler to operate and will make work pay. He described the effects of the Act as producing the biggest reforms for 60 years that will change the lives of millions of households, providing support to the most vulnerable people in society, with around 2.8 million low to middle income households better off and around 900,000 adults and children lifted out of poverty under Universal Credit (UC).

UC has been replacing, from October 2013, the current complex system of means-tested benefits (the 6 benefits being replaced are listed in the UC section, 1.2.1, below) with a single benefit system. Employers are also being involved in the payment of benefits and this is considered in section 1.1. The reforms also include a household benefit cap (see section 1.2.10 for further detail) (this element largely affecting the south east was completed by September 2013), a new Personal Independence Payment to replace Disability Living Allowance and tougher penalties for benefit fraudsters.

Whatever the reader's views on the reforms, they are on the Statute book. They will also be changed in future (even after the current phasing in) but for the moment, the following sections set out the present position including the main benefits payable. The financial adviser needs to factor these benefits into the suitability equation prior to presenting solutions to his client. NB. Because of the complexity of State benefits, many of the minor benefits and adjustments to the main State benefits are not covered in this Chapter. Such detail is beyond the scope of this course. Each client should be advised to check into his own circumstances to ascertain what State benefits might be available for himself and his family.

1.1 STATUTORY BENEFITS PAID BY THE EMPLOYER

1.1.1 Statutory Sick Pay (SSP)

When an employee is unable to work due to sickness or disability, employers must make payments for time off sick to at least a minimum level. Therefore, during the first 28 weeks of time off work employers must, as a minimum, make statutory payments.

SSP is payable at a flat rate of £94.25* per week from 6 April 2019 irrespective of the employee's income (although the employee would have needed to have earned above the £118 weekly Earnings Threshold to qualify for this flat-rate payment). SSP is only payable after the employee has been off work sick for at least four consecutive days (including weekends and holidays). SSP is paid through the employer's payroll and any liability for income tax and/or National Insurance contributions (NICs) is deducted at source in the usual way. The employer will normally pay the employee in the same way and on the same day that the employee would normally receive his or her wages. SSP is not a means tested benefit.

* Agricultural workers are entitled to significantly higher benefits when off sick.

To be eligible for SSP the employee must earn at least enough to pay Class 1 NICs. If the earnings threshold is not met then Income Support may be claimed, although this is a means tested benefit. SSP is limited to a maximum payment period of 28 weeks, but different periods of sickness may be linked for this purpose if they are at least four days in a row and less than eight weeks apart. If sickness/disability continues after the end of the 28 week period then incapacity benefit may be claimed.

1.12 Statutory Maternity Leave (SML) and Statutory Maternity Pay (SMP)

Employees eligible for SML can take up to 52 weeks' maternity leave.

Employees must take at least two weeks after the birth (or four weeks if they are a factory worker).

The earliest leave can be taken is 11 weeks before the expected week of childbirth.

SMP for eligible employees can be paid for up to 39 weeks, usually as follows:

- the first 6 weeks – 90% of their Average Weekly Earnings (AWE) before tax
- the remaining 33 weeks – £148.68 per week (from April 2019) or 90% of their AWE (whichever is lower).

The employee would have needed to have earned above the £118 weekly Earnings Threshold (from April 2019) to qualify.

Tax and National Insurance need to be deducted from SMP payments.

Note Maternity Allowance may be available for those not qualifying for SMP (e.g. low earners and self-employed) but this is payable by the State.

1.13 Statutory Paternity Leave and Statutory Paternity Pay

Employees eligible for Ordinary Statutory Paternity Leave can choose to take either one week or two consecutive weeks' leave – even if they have more than one child (e.g. twins).

Leave cannot start before the birth. The start date must be one of the following:

- the actual date of birth
- an agreed number of days after the birth
- an agreed number of days after the expected week of childbirth.

Leave must finish within 56 days of the birth.

Statutory Paternity Pay for eligible employees is either £148.68 per week (from April 2019) or 90% of their average weekly earnings (whichever is lower). It is payable for up to 39 weeks.

The employee would have needed to have earned above the £118 weekly Earnings Threshold (from April 2019) to qualify.

Tax and National Insurance need to be deducted from SPP payments.

1.14 Statutory Adoption Leave (SAL) and Statutory Adoption Pay (SAP)

Eligible employees can take up to 52 weeks SAL.

Leave can start:

- on the date the child starts living with the employee or up to 14 days before the expected placement date (UK adoptions)
- when an employee has been matched with a child to be placed with them by a UK adoption agency
- when the child arrives in the UK or within 28 days of this date (overseas adoptions).

SAP for eligible employees is £148.68 per week (from April 2019) or 90% of their gross average weekly earnings, whichever is lower. It is paid for up to 39 weeks of adoption leave.

The employee would have needed to have earned above the £118 weekly Earnings Threshold (from April 2019) to qualify.

Tax and National Insurance need to be deducted from SAP payments.

1.15 Shared Parental Leave (SPL) and Statutory Shared Parental Pay (ShPP)

A person may be entitled to Shared Parental Leave (SPL) and Statutory Shared Parental Pay (ShPP) if:

- the baby is due on or after 5 April 2015
- they adopt a child on or after 5 April 2015.

SPL and ShPP must be taken between the baby's birth and first birthday (or within 1 year of adoption). Partners can share the leave if they are both eligible for SPL, and choose how much of the leave each will take. The mother must take a minimum of 2 weeks' maternity leave following the birth (4 if she works in a factory) but then either partner can:

- take the rest of the 52 weeks of leave (up to a maximum of 50 weeks) as Shared Parental Leave (SPL)
- take the rest of the 39 weeks' pay (up to a maximum of 37 weeks) as Statutory Shared Parental Pay (ShPP)

ShPP is paid at the rate of £148.68 per week (from April 2019) or 90% of average weekly earnings, whichever is lower.This is the same as SMP except that during the first 6 weeks SMP is paid at 90% of whatever the mother earns (with no maximum).

The employee would have needed to have earned above the £118 weekly Earnings Threshold (from April 2019) to qualify.

(Prior to April 2015, Additional Statutory Paternity Pay was available: ShPP has replaced this benefit.)

1.16 Employer's Reclaim of Statutory Benefits

Reclaims against NICs are no longer possible for employers who have paid SSP. From 6 April 2014 the employers' right to reclaim SSP was withdrawn. Prior to that date it was possible for employers to claim back SSP paid which was particularly helpful to small employers but the Government, because it felt employers were not encouraging their staff to return to work decided to save about £50,000,000 – under their Health,Work and Well-Being Initiative.To compensate, the Government introduced the Employment Allowance in April 2014 meaning that businesses and charities will be given an annual discount of £2,000 on their National Insurance Contributions bill (or exempted from paying NICs if their NICs bill is less than £2,000 in tax year).The £2,000 figure increased to £3,000 in 2016. However that may be of limited help to a small employer who needs to pay SSP for a lengthy period.

Reclaims of SMP, SPP, SAP and ShPP are more straightforward in that payments made can be offset against NICs or tax without limit. From 3 April 2011, the employer can then claim back either:

- 92% of any SMP etc. payment made, or
- 103% if they qualify for Small Employers Relief (SER) threshold of £45,000. (The extra 3% is to help compensate for NI paid on SMP etc.) A small employer is one whose total Class 1 NICs, including primary (employee) and secondary (employer) liability, is at or below the SER threshold, in the tax year.

Where the employer has a different and more generous absence policy then additional non-reclaimable benefits may have been paid in excess of the maternity/paternity benefits described above.

1.2 OTHER BENEFITS PAID BY THE STATE

Individuals might also claim the following (there are other State, and local authority, benefits payable in certain circumstances which are not outlined below):

1.2.1 Universal Credit

Universal Credit (UC) is a new single payment for people who are looking for work or on a low income. It is designed to help claimants and their families to become more independent and will simplify the benefits system by bringing together a range of working-age benefits into a single payment.

Introduced in October 2013 (following the "pathfinder" trial in the North-West of England from April 2013) it is replacing:

- income-based Jobseeker's Allowance
- income-related Employment and Support Allowance
- Income Support
- Child Tax Credits
- Working Tax Credits
- Housing Benefit.

It is gradually being extended to JobCentre Plus offices throughout the UK on a geographical basis.

The Government stated in its policy guide* *Simplifying the welfare system and making sure work pays:* "We will introduce Universal Credit in a managed way, progressively rolling it out nationally from October 2013. The transition from the current system of benefits and tax credits to Universal Credit will be gradual and it is expected to be completed by the end of 2017."

* The guide was published on 16 April 2013 and is regularly updated. It contains an extensive journal of past changes and updates.

The process of replacing other benefits by UC is ongoing. Some work has been done in this area, more needs to be done. It was intended before its launch that completion of the reforms would have been finalised by 2015/16; by then approximately 12 to 13 million tax credit and benefit claims would have been transformed into eight million UC payments. But roll-out problems and delays have meant that the Government has accepted that completion will not now be finalised until 2021. (The Opposition have suggested that it will take much longer: Stephen Timms, the acting Shadow Work and Pensions Secretary, called for the Government's spending watchdog, the National Audit Office, to review the management of the scheme. He commented in June 2015 (report in The Guardian on 25 June) that "new figures have shown how wrong Iain Duncan Smith is to claim UC is 'on time and on budget'. It will take 495 years to fully roll out Universal Credit at the current rate". Politicians! But advisers and the public have to deal with the results of their work and will appreciate that no claimants of pre-UC benefits, who were working in 2012, will be under SPA in less than 50 years' time!) The Government has published and will continue to publish Regulations relating to the Welfare Reform Act 2012 and its introduction of UC. A Commons Select Committee sat on 13 September 2017 to consider evidence concerning the practical hardships, particularly delays in UC payment contributing to rent arrears, experienced by claimants in the roll-out of UC. That Committee and subsequent debates in the House suggest that the revised March 2021 completion date will not be achieved. Meantime, the Government has reduced, by one week, to five weeks the period which new UC claimants need to wait before their UC payments start and from February 2018 will remove the 7-day waiting period during which no UC benefits accrue.

The main differences between UC and the welfare system it is replacing are:

- UC will be available to people who are in work and on a low income, as well as to those who are out of work
- most people will apply online and manage their claim through an online account
- UC will be responsive – as people on low incomes move in and out of work, they will get ongoing support, giving people more incentive to work for any period of time that is available
- most claimants on low incomes will still be paid UC when they first start a new job or increase their part-time hours
- claimants will receive just one monthly payment, paid into a bank account in the same way as a monthly salary
- support with housing costs will go direct to the claimant as part of their monthly payment (though this aspect is now under review given problems with some tenants).

To get UC the claimant must:

- be 18 or over
- be under State Pension Age
- not be in full time education or training
- not have savings over £16,000.

The standard amounts of UC Basic Allowance [Source gov.uk Universal Credit Guide] (and no changes are planned to these amounts for four years from 2016 or have taken place since then) are

	2019/20 £ per month
Single under 25	251.77
Single 25 or over	317.82
Joint claimants both under 25	395.20
Joint claimants, one or both 25 or over	498.89

The above amounts represent the maximum amounts payable. If anyone in the claimant's household has earnings, income, capital or savings then these need to be taken into account.

Additions are payable for children and where disability, carer and childcare elements apply, subject to an overall benefits cap (see section 1.2.10 below). From April 2017 tax credits and family benefits under UC are limited to the first two children only. Any family which has a third or subsequent child born after April 2017 will no longer qualify for additional tax credits.

For every £1 earned UC payment will be reduced by 63p. Those claimants responsible for a young child or have a disability or health condition are entitled to a work allowance of £192 a month or £397 if they do not get help with housing costs.

1.2.2 Incapacity Benefit

Incapacity benefit has continued for existing claimants whose disability or illness commenced before 27 October 2008, being replaced by the Employment and Support Allowance (ESA) from 2009. Since 31 January 2011, no new incapacity claims have been accepted. Claimants receive ESA instead.

Incapacity benefit can be paid at three different rates:

- Short term incapacity benefit at the lower rate
- Short term incapacity benefit at the higher rate, or
- Long term incapacity benefit.

Short Term Incapacity Benefit

Where there is no entitlement to SSP, for example where the individual is self-employed or where SSP has ended, incapacity benefit is payable in the event that sickness or disablement prevented the individual from working for at least four consecutive days. This is in the form of short term incapacity benefit and is payable at the lower rate for a maximum of 28 weeks.

The payment is £84.65 per week, but increased where there is any adult dependant or the claimant is over the State Pension Age. This benefit is tax free.

The higher rate of short term incapacity benefit is relevant to both the employed and self-employed and is payable from week 29 to week 52.This is a potentially taxable benefit.The claimant's benefit is £100.20 per week.

Long Term Incapacity Benefit

Long term incapacity benefit is payable from week 53 in respect of both the employed and the self-employed. This is a potentially taxable benefit and is currently £112.25 per week.

In addition, if claimants were under age 45 when they first became unable to work (this includes days of SSP) they can claim an Incapacity Age Addition at either the lower rate of £6.60 a week (if the claimant was aged between 35 and 44, inclusive) or the higher rate of £11.90 a week (if the claimant was aged under 35).

An additional adult dependant's allowance is payable if the claimant's partner is over the age of 60 or the claimant has dependent children. Incapacity benefit ceases on resumption of work, when the individual is considered capable of work or at State Pension Age (whichever is earlier).

People who are entitled to a Long Term Incapacity Benefit who have worked and paid, or are treated as having paid full rate Class 1 NICs for at least 10% of their working life since 1978, may accrue additional State pension through the State Second Pension.

1.2.3 Employment and Support Allowance (ESA)

ESA replaced all incapacity benefits for all new claimants with effect from 27 October 2008. Employees will continue to receive SSP for the first 28 weeks of absence. For those not eligible for SSP (e.g. the self-employed), ESA will commence in place of SSP following four consecutive days of illness. Note that ESA is paid by the Government; SSP is paid by the employer.

At the end of the 28 week period of SSP, there is a 13 week assessment period which, in addition to using means testing or a claimant's NIC history to establish eligibility, requires the claimant to demonstrate the extent to which their illness or disability prevents them from working. This "assessment phase" is known as the Work Capability Assessment (WCA): it replaced what was previously known as the "Personal Capability Assessment".

During the assessment phase, an employee receives a benefit broadly equivalent to Jobseekers Allowance, i.e. £57.90 a week for a single person aged between 16 and 24 and £73.10 a week for a single person above age 25. This is less than the amount paid under the short term incapacity benefits being replaced (see above). The migration (as the Government calls it) of claimants to ESA from the old Incapacity Benefits, and which started in October 2010, should have been completed by March 2014 but there was an overrun.

Throughout the assessment phase, the claimant will be invited to attend several work-focused interviews with a personal adviser. The outcome of these interviews will be to establish one of three possible results at the end of the assessment phase:

- the claimant has a limited capability for work (those that can be rehabilitated back into the workplace)
- the claimant has a limited capability for a work related activity (the most severely incapacitated who realistically are not expected to return to work)
- the claimant does not qualify for benefit (and benefit will cease).

It is possible to extend the assessment phase beyond 13 weeks in certain circumstances, e.g. if the claimant is too ill to attend an examination. In such cases, the claimant will continue to receive the initial rate of benefit but once they have been assessed the "main phase" rate of benefit will be backdated.

All claimants assessed as being unable to work at the end of the assessment phase will receive a basic allowance of £73.10, i.e. equivalent to jobseekers allowance for over 25s. An additional benefit may also become payable if the claimant is disabled - the amounts depend on the level of disability - or has responsibility for dependent children.

1.2.4 Personal Independence Payment/Disability Living Allowance

The replacement of Disability Living Allowance by the Personal Independence Payment is a part of the major changes being introduced by the new welfare system the replacement of benefits will be phased in.

For new claimants and those under 65 in April 2013, qualifying claimants now apply for the Personal Independence Payment. The standard weekly amount is £58.70: enhancements apply for the Daily Living and Mobility Components where the claimant qualifies.

Disability Living Allowance is being replaced by the Personal Independence Payment starting 8 April 2013 for claimants up to the age of 64. Disability Living Allowance was designed for those who because of illness and disability need help with personal care, supervision, or need someone to care for them because of physical or mental disability, or because they are unable to walk or have difficulty in walking or need someone to be with them when walking outdoors. It also covers those who have both care and mobility needs. These needs must have developed before the age of 65 resulting in the claimants being too young to claim Attendance Allowance. The Middle Rate of Disability Living Allowance, Care Component, is £58.70 per week. Lowest and Highest rates also apply and an additional Mobility Component may be payable

1.2.5 Industrial Injuries Disablement Benefit

Entitlement for this benefit, otherwise known as "the disablement pension", is for those who have become disabled as a result of an accident or the contraction of a prescribed industrial disease during employment (or approved training for employment); there are over 70 listed diseases. This benefit is not means tested and there is no consideration of the claimant's NIC record. This benefit is not available to the self-employed. The amount of benefit payable depends upon the extent of disablement as a consequence of the accident or prescribed disease. An assessment is undertaken by an independent adjudicating authority. The maximum rate of benefit is £179.00 per week with a sliding scale for persons less than 100% disabled.

1.2.6 Income Support

The purpose of Income Support is to top up the income of those whose income from all sources is below a minimum threshold level set by Government. It is one of the benefits being replaced by Universal Credit.

Income Support is payable to those who meet the following main conditions (there are other minor qualification conditions):

- between 16 and Pension Credit qualifying age
- pregnant, or a carer, or a lone parent with a child under 5 or, in some cases, unable to work because you're sick or disabled
- you have no income or a low income (your partner's income and savings will be taken into account)
- working less than 16 hours a week (and your partner works less than 24 hours a week)
- living in England, Scotland or Wales – there are different rules for Northern Ireland You don't need a permanent address, e.g. you can still claim if you sleep rough or live in a hostel or care home.

The following circumstances will disqualify a person from claiming:

- have savings above £16,000 (savings of £6,000 or more will mean that Income Support will be limited)
- need permission to enter the UK
- get Jobseeker's Allowance or Employment and Support Allowance
- are a young person being looked after by a local authority.

The basic amount (April 2018) for a single person aged 16 to 24 is £57.90 per week, increasing at 25 (or 18 if lone parent) to £73.10. Higher rates up to £128.60 per week are payable for couples, couples with children and those claimants who are disabled – generally taken to be in receipt of relevant State benefits such as Personal Independence Payment.

1.2.7 Severe Disablement Allowance

Since April 2001 it had not been possible to make a new claim for Severe Disablement Allowance (SDA).

1.2.8 Pension Credit

On 6 October 2003, Income Support for people over 60, including care home residents, was replaced by a new benefit – the Pension Credit. Pension Credit is administered by the Pension Service which is part of the Department for Work and Pensions (DWP). People aged 60 and over who were already receiving Income Support in October 2003 were transferred automatically to Pension Credit without having to make a new claim.

Pension Credit has two parts: the "Guarantee Credit" and the "Savings Credit"; the Guarantee Credit is designed to ensure people have enough to live on, while the Pension Credit is a way of recognising a person's past efforts to provide for himself. The Guarantee Credit can top up the claimant's weekly income if it is (2019 figures) below £167.25 for single people and £255.25 for a couple. The Savings Credit provides extra incomes for those aged 65 and over that have only modest savings, investments and income. A single person can claim up to an extra £13.73 per week and a couple, £15.35 per week. Savings Credit was not expected to be available for those reaching State Pension Age on or after 6 April 2016 when the new single-tier pensions started but it will continue for a while longer yet). Pension Credit is not taxable.

To qualify for Guarantee Credit:

- the claimant must live in Great Britain
- the claimant or their partner must have reached Pension Credit qualifying age (the qualifying age for Pension Credit is gradually going up to 66 in line with the increase in the State Pension age for women to 65 and the further increase to 66 for men and women.)

To qualify for the extra Savings Credit the claimant or their partner must be 65 or over (treated as a couple if the claimant lives with husband, wife or partner – the claimant does not have to be married or in a civil partnership).

Existing income, which is offset, is calculated at the time of application: it includes:

- State Pension
- other pensions*
- most social security benefits, e.g. Carer's Allowance
- savings, investments over £10,000 – for these £1 is counted for every £500 or part £500
- earnings.

* if a claimant is entitled to a private or workplace pension, the amount they expect to get is calculated as income from the date they were able to get it, had it been claimed. Claimants will not get the benefit of deferring their State Pension if on Pension Credit (i.e. no extra State Pension build-up or a lump sum for deferring State Pension. When working out Pension Credit, allowance is made for the State Pension whether being claimed or not.

Pension Credit may be enhanced if the claimant is disabled, a carer or if help is required with housing costs.

Pension Credit ceases to be available if the claimant moves abroad permanently.

1.2.9 The Benefit Cap

From April 2013, the Government started introducing a cap on the total amount of benefits that working-age people (i.e. 16 to 64) could receive.This means that households on working-age benefits can no longer receive more in benefits than the average wage for working families.The Government confirmed in its updated policy guide that 51,000 claims had been capped in the first year of operation up to August 2014. The total number of households capped in February 2017 had risen to 66,000 (excluding households no longer capped). [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/612393/benefit-cap-statistics-to-feb-2017.pdf]

The cap applies to the total amount the household gets from the following benefits
[Source: https://www.gov.uk/benefit-cap - data checked December 2017]

- Bereavement Allowance
- Child Benefit
- Child Tax Credit
- Employment and Support Allowance
- Housing Benefit
- Incapacity Benefit
- Income Support
- Jobseeker's Allowance
- Maternity Allowance
- Severe Disablement Allowance
- Universal Credit
- Widowed Parent's Allowance (or Widowed Mother's Allowance or Widow's Pension that started before 9 April 2001).

The level of the cap from November 2016 (having been reduced from its 2013 starting level) is as follows:
if you live outside a Greater London borough, the cap is:

- £384.62 per week (£20,000 a year) if you're in a couple, whether your children live with you or not
- £384.62 per week (£20,000 a year) if you're single and your children live with you
- £257.69 per week (£13,400 a year) if you're single and you don't have children, or your children don't live with you

if you live in a Greater London borough, the cap is:

- £442.31 per week (£23,000 a year) if you're in a couple, whether your children live with you or not
- £442.31 per week (£23,000 a year) if you're single and your children live with you
- £296.35 per week (£15,410 a year) if you're single and you don't have children, or your children don't live with you

This may mean the amount claimants get for certain benefits will be reduced.

In recognition of the additional needs that disability can bring, the cap will not apply if the claimant:

- works enough hours to get Working Tax Credit (even if not claiming it)
- over Pension Credit age
- gets Universal Credit because of a disability or health condition
- gets Universal Credit because caring for someone with a disability
- gets Universal Credit and the household's monthly income is more than £520 after tax and National Insurance contributions

The Benefit Cap also does not apply if the claimant, his partner or any children under 18 living with him gets:

- Armed Forces Compensation Scheme
- Armed Forces Independence Payment
- Attendance Allowance
- Carer's Allowance
- Disability Living Allowance (DLA)
- Employment and Support Allowance (if you get the support component)
- Guardian's Allowance
- Industrial Injuries Benefits (and equivalent payments as part of a War Disablement - Pension or the Armed Forces Compensation Scheme)
- Personal Independence Payment (PIP)
- War pensions
- War Widow's or War Widower's Pension

1.2.10 The Working Tax Credit

Following the replacement of the disability working allowance with the disabled person's tax credit from 5 October 1999, the latter was in turn replaced by the Working Tax Credit from 6 April 2003. Note that Working Tax Credit is one of the benefits being replaced by Universal Credit. This benefit is administered and paid four-weekly by HMRC's Tax Credit Office. [Source for data in this sub-section: https://www.gov.uk/working-tax-credit/eligibility]

The Working Tax Credit is designed to help those who, whether employed or self-employed, are over the age of 16. Claimants must be 25 or over if they do not have children or a disability. The claimant must work a certain number of hours a week to qualify.

Circumstance	Hours a week
Aged 25 to 59	At least 30 hours
Aged 60 or over	At least 16 hours
Disabled	At least 16 hours
Single with 1 or more children	At least 16 hours
Couple with 1 or more children	Usually, at least 24 hours between you (with 1 of you working at least 16 hours)
A child is someone who is under 16 (or under 20 if they are in approved education or training).	

The purpose of the Working Tax Credit is to support working households with limited incomes by topping up their earnings. The Tax Credit, the basic amount being £1,960 per annum, is made up of a number of elements depending upon the claimant's circumstances and can include extra elements for those who are working and have a disability. The exact amount is calculated allowing for the claimant's circumstances and an on-line tool facilitates this.

Summary

In Chapter 2 we considered some of the sources of income that are available to those who are unable to work because of sickness or disability, payable by either their employer as statutory benefits or direct from the State, including:

- Statutory Sick Pay
- Universal Credit
- Employment Support Allowance (replacing Incapacity Benefit)
- The Working Tax Credit
- Personal Independence Payment (Disability Living Allowance)
- Industrial Injuries Disablement Benefit
- Income Support
- Pension Credit.
- Severe Disablement Allowance

We explored the structure and basic eligibility requirements of each benefit and the current payment rates.

We also looked at the Benefit Cap.

Self-Test Questions

- After what period of sickness is Statutory Sick Pay applicable?
- At what date was the Employment and Support Allowance (ESA) introduced, and how has this affected State incapacity benefits already in payment?
- How is the Working Tax Credit administered and who is it designed to help?
- What do you understand by the State Benefit Cap?

INTRODUCTION

It is anticipated that State benefits will become smaller and harder to obtain following the Government's reforms. The UK's legislators are looking much more closely at the eligibility of persons to claim benefit. For those of working age, the simplification of benefits and charging JobCentre Plus benefit advisers with the task of supervising claimants' return to work, including their ability to work if there are possible medical conditions. For retired people the Government's intention is that the new single-tier State Pension will be sufficient to live on without claiming benefits, particularly when coupled with the ability to build extra private pensions benefits on top without seeing those extra benefits in effect being used to "subsidise" in part State benefits they could otherwise have claimed. Along with earlier legislation contained in the Disability Discrimination Act, under which an employer has to make "reasonable adjustments" to enable a disabled employee to continue working, a greater focus is also being placed upon employers playing a bigger part in helping their employees return to work. Early intervention is generally proven to achieve more effective results, thereby resulting in the most positive outcome for all parties.

Where an individual is self-employed, or where the employer does not provide sufficient additional benefits to protect a person should they be unable to work, there are a number of insurance products available.

Just as the adviser needs to know about State benefits before he can advise his clients, it is also necessary for the adviser to have a good understanding as to how group benefits operate to make full use of these for clients before advising them on top-ups or alternatives. We looked at group pension benefits in Part 1 of this study manual and we will look at other group benefits in this Part.

2.1 INCOME PROTECTION

Income protection can be provided in a number of ways. Where the individual is an employee the employer will provide at least the statutory minimum level of cover and this minimum level may be augmented. Benefits can be provided at various levels, short or long term, by the employer. Where the employer does not provide benefits over and above the statutory minima, individuals can augment their protection. For the self-employed, any income protection above that offered by the State will probably be provided by insurance cover.

2.1.1 Short Term Employer Provision

Many employers pay more than the minimum Statutory Sick Pay and may pay an employee his normal earnings for a period, the length of which may be service related. This short term provision is often non-insured, in effect self-insured. It is designed to fill the gap between the employee first becoming ill and any long-term arrangement coming into payment.

2.1.2 Long Term Employer Provision

The provision of long term benefit in the event of long term disability may be made by employers through long term sickness and disability arrangements generally known as Permanent Health Insurance (PHI) or as Income Protection (IP).These may or may not be insured through a PHI insurance policy. PHI benefits may be provided for all employees or perhaps just for certain categories of employee, e.g. senior executives or managers.

The design of such arrangements should take account of a number of factors including:

- allowing for the existence of short term benefit provision from the employer and/or the State, longer term State help also needs to be considered
- any available provision for retirement on the grounds of incapacity under any occupational pension scheme that may be in place
- where there is no prospect of a return to work, expected pension benefits.

213 Permanent Health Insurance Arrangements

Many employers will have group PHI benefit arrangements designed to cater for the income needs of employees who suffer long term disability. These are normally linked to the employee's contract of employment so that the employer continues to pay salary at the full or a reduced rate for an initial period before the group PHI benefit commences.

As PHI arrangements are for the purpose of covering long term sickness and disability it is usual for there to be a waiting period before benefit is payable in the event of a claim. Typically a waiting period of 26 weeks might be chosen as a suitable scheme design but schemes may be set up with other waiting periods. 28 weeks to fit in with SSP perhaps? Or as short as 13 weeks for company schemes (and shorter still for self-employed workers) or as much as 52 weeks. The chosen waiting period should ideally link in with short term provision so that there is continuous coverage of income for the employee. As far as the employer is concerned, the cost of the benefit will also be a factor in determining its length.

Generally, the benefit payable will link with long term State provision whilst maintaining at least some financial incentive to return to work. The level of benefit is specified as a percentage of gross or net pre-incapacity earnings, as outlined below:

- Gross Pay Policy – Benefits are specified as a percentage of gross pre-incapacity earnings. The normal maximum benefit that can be insured for each employee is 75% of pre-incapacity earnings, less the basic long term rate of ESA payable to a single person and any other benefits which the employee might receive in the event of his incapacity, (for example any payments from private PHI provision which he may havemade).
- Net Pay Policy – Benefits are specified as a percentage of net pre-incapacity earnings.The normal maximum benefit you can insure is 90% of net pre-incapacity earnings after taking into account ESA actually received. Insurers no longer offer this for new business but continue to cover existing arrangements.

For group contracts it is also possible to insure pension contributions and National Insurance contributions paid by the employer, so that in the event of an employee's sickness, not only pay but also these additional items will be insured.

Under normal circumstances, benefit under the PHI arrangement for an employee ends:

- when they leave company employment or are no longer eligible to be a member
- when they reach the benefit termination date under the PHI scheme which will normally coincide with State Pension Age or the normal retirement age under any pension scheme of the employer if different
- if they retire early
- if they die
- if they make a full return to work
- if they cease to meet the definition of incapacity.

Each insurer will set a maximum benefit formula on the policy and this is determined at the beginning of the policy. This maximum will be reviewed both in line with market changes and the number of members in the group policy.

Exclusions

Under most policies there will be a range of circumstances under which a claim will not be met. Claims resulting from illegal activities, drug-taking, intentional self-harm are typically excluded. But it is unusual on group policies for there to be any other restrictions, unless the benefits are particularly high. Most group policies, other than those for small groups of lives (say less than six but the figure varies from insurer to insurer) offer a Free Limit below which no evidence of health is required and therefore the cover starts immediately, provided the employee

is actively working at the date the cover starts. So if a Free Limit of £70,000 benefit p.a. is offered, only those employees earning over £140,000 if the benefit is 50% of salary would need (in the first instance) to complete medical forms. Exclusions for claims arising from certain specified medical conditions or in specified circumstances may be imposed on a specific member's benefits as part of the medical underwriting process. More usually on group policies a loading on the premium would be applied. An example of a premium loading might be "an extra £1.50 % of benefits in excess of the Free Limit for claims arising from medical condition X".

Design Features

PHI arrangements are provided to protect an employee's income should they need to take time off work for sickness. The design features of an insured scheme may include:

- the conditions that an employee must meet to be eligible are defined in the PHI policy, including age, salary, employment category etc.
- the requirement to be actively at work when cover commences or when increments are required. The precise wording will depend on the insurer; it may be limited to "in full time employment at the normal place of work in the month preceding the date (increased) cover starts" but could be qualified to exclude claims from medical conditions which have prevented the employee from working during periods exceeding, say four consecutive weeks in the 12 months preceding the cover start date
- a proportionate benefit may be payable if a part time return to work is possible or if it becomes possible for a lower paid job to be taken
- employers may choose, when the cover first start, to offer benefits which increase in payment to protect against inflation for example, or to increase them at a fixed rate, say 3% or 5% p.a.. Or they can choose to keep benefit payments level
- the payment of PHI benefit under a PHI benefit arrangement can be provided up until normal retirement age. Or a specific limited period of two, three or five years can normally be selected. The limited payment period will limit employer's cost but still allow them to provide some benefits for their employees
- payment of benefit is normally made to the employer and administered through the payroll system, though some insurers will allow "pay direct"
- payment of premiums is almost invariably made by the employer on group PHI schemes since such premiums rank as a trading expense for Corporation Tax purposes. Contributions made by employees are not tax-relievable. Nonetheless, recent flexible pay arrangements under which employees can chose to use an allocated percentage of their pay on pension or protection benefits (or child-care vouchers and potentially an extensive list of other benefits) may well see employee contributions being allocated to PHI benefits
- it may be possible to insure a lump sum at the end of a limited benefit payment term, provided the claimant still meets the definition of incapacity, e.g. a lump sum equivalent to the pension contributions that would have been paid for that employee to retirement age. This could then be paid into the employee's pension pot, providing them with an income in retirement
- incapacity or disability can be defined in different ways according to the types of illness, injury and circumstances the policy covers. A claim will be paid if the ill or injured employee meets the definition of incapacity that is selected under the policy. Group policies use different generalised definitions of incapacity:
  - unable to perform their normal occupation,
  - unable to perform a suited occupation, or
  - unable to perform any occupation.

  The first of these three definitions is better for the employee but more expensive. Insurers may require a "suited" definition to apply after, say, two years.

Costing

The premiums charged for a particular arrangement depend on a number of factors. These include the age, occupation and locations of the employees to be covered, as well as the actual benefits being provided, the termination age (including whether or not the term is limited), the rate of any increase in payment and the length of the chosen deferred period. Gender used to be an important factor but anti-discrimination legislation forced insurers to disregard this as rating factor from private polices from 21 December 2012.The nature of the unit rate method of costing means that the same factor is applied to all benefits (see following paragraph) although gender may still be taken into account by the insurer in assessing group premiums.

Costing is very similar in nature to Group Life business.It will either be calculated on a single premium basis to cover each year, effectively aggregating the premiums attributable to each individual based upon their age and gender, or on a unit rate basis. Under the latter method a rate applicable to the entire arrangement is calculated based on the variables already described in the above paragraph.

The unit rate method is accounted for using simplified administration.This means that an annual rate of premium applicable to all members (referred to as the Unit Rate or Flat Rate) is calculated at the start of the guarantee period. Unit rates are usually guaranteed for two years and are subject to review thereafter. New rates may apply at the end of this period. If the membership changes substantially, by more than, say, 20% before the unit rate expires (e.g. an acquisition, merger, or redundancy exercise), the insurer may reserve the right to review the unit rate. A review of the unit rate would also be required if the level of benefits or eligibility conditions changed.

For unit rate costed schemes, details of individual employees who join or leave mid-year are not required; the only information required at a mid-rate guarantee policy accounting date is the total number of members and total salary roll or total benefit roll at that date. Individual details are required only for any members whose benefits exceed the Free Limit or who are joining outside the normal eligibility conditions of the policy (e.g. late entrants).

214 Tax Treatment

The whole cost of a standard group PHI policy is usually met by the employer. For tax purposes, premiums are treated as a business expense. Any employee contributions would not receive any tax relief.

Income benefit is payable to the employer who passes it on to a claimant as a salary continuance. Income benefit received by the employer is a trading receipt and payments passed only the employer as salary are a trading expense, giving the employer a neutral tax situation. Income benefit received by the employee as salary is taxed as PAYE. National Insurance contributions are also payable on the usual basis.

Premiums are not treated as a P11D benefit for employees. However if the arrangement includes controlling directors and the employer is a director controlled company then the premiums attributable to the directors will be disallowed for relief if the benefits being provided for the directors are materially different to those being provided for at least some of the other employees.

HM Revenue & Customs does not normally grant tax relief on premiums paid for any employees with a proprietorial interest in the company. However, it may sometimes grant tax relief provided that a substantial number of other employees are entitled to similar benefits.

Employees themselves or the self-employed may take out an individual PHI policy but there will be no tax relief available on the premiums. However, as a quid pro quo, it is likely that any claim payments would be excluded benefits allowed under section 202(1)(c) ITEPA 2003.

If the employer is a partnership, partners may be included in a group scheme but there will not be any tax relief on their premiums. But then any benefit received would not normally be subject to tax and would be regarded as a s202 excluded benefit.

2.2 LIFE ASSURANCE

Life assurance provides financial protection for dependants in the event of an individual's death. Whether or not they need to buy life assurance will depend on personal circumstances. If they have no dependants it will be of low priority, and it may be provided through their job in any event. If they have a mortgage, a mortgage protection policy may be in place to pay off the outstanding loan or the cover may be in place as part of an endowment mortgage arrangement. Where they already have some life assurance, the decision on whether they need to buy more will depend on how much replacement income, or lump sum to pay off debts, would be needed by their dependants.

What they pay for term assurance is set when they take out the policy and depends on a number of factors. Naturally, the larger the sum they want to be insured for and the longer the length of time they want the policy to cover them for, the more expensive their premiums will be. The other main factors which influence the cost of the premium are their age and state of health. Gender also used to be a factor prior to 21 December 2012 at which date insurers were no longer permitted to use gender as a factor in calculating premiums.

When they choose to apply for life assurance as an individual, they will need to give details of their medical history so that the insurer can assess if there is an increased risk of a claim. If they have had health problems in the past, or if they want to insure for a particularly large amount (what is considered a large amount varies from insurer to insurer, on the reason for the cover and the applicant's age), their insurer is likely to ask them to provide a medical report from their GP. They could also be asked to attend a medical examination by a doctor chosen by the insurer.

Life assurance provided as part of a group scheme offered by an employer is likely to be significantly less expensive and probably will not require the submission of medical and health details. This is because the insurer is accepting premiums for an average group of lives and this premium is calculated on factors including the age of the lives insured, the work they do and the location their employment is based. Most of these lives will be in good health and very few in poor health. Obtaining evidence of health in these circumstances would be time-consuming, expensive and substantially unnecessary. It is therefore avoided and a Free Limit offered. The Free Limit depends on the underwriter's own judgement but typically can exceed £500,000 benefit for relatively small groups of lives, perhaps as small as 10. The Free Limit is offered provided all members receive the same level of benefits e.g. a flat rate or a common multiple of salary. For higher paid employees or directors in salary-related life assurance scheme, benefits might exceed the offered Free Limit. If so the excess is subject to evidence of health which could take the form of a medical examination but more likely a questionnaire (which nowadays could take the form of a telephone interview) If differential benefits are provided i.e. the directors' category enjoys benefits of 4x salary while other staff receive 3x salary then the underwriter may require all the directors' excess benefits, 1x salary, to be subject to evidence of health. Another protection for the underwriter which may well be built in when a new scheme starts or when the benefit basis is improved is an actively-at-work requirement. Even people on low benefits can be subject to this requirement. The precise terms of the actively-at-work clause will vary but typically cover will not start unless employees are actively performing their normal duties and have not been absent as a result of sickness for more than, say 14 consecutive days in the last three months. If that applies then commencement of their cover could be deferred or refused or subject to medical enquiries. If any person is found to be in poor health then, as well as refusing to cover that person, the underwriter can impose a loading on the premium to compensate for the extra risk. Where a Free Limit has been offered (and an actively-at-work exclusion does not apply) then the loading is applied only to the excess cover above the Free Limit. This is because in setting their rates the insurer allows for a small element of the insured group to be in less than average health.

Benefits provided by group life policies are tax advantaged. Premiums paid by their employers are not taxed on employees as benefits-in-kind, though any contributions made by the employee, under a Flexible Benefits scheme perhaps, do not benefit from tax relief. In the event of a death claim then because the life assurance scheme would almost certainly have been written under a discretionary trust then benefits paid to beneficiaries would be paid promptly and without charge to Inheritance Tax.

Excepted Life arrangements

Occasionally, relevant life policies are set up for key persons to provide for their family beneficiaries.

Relevant life policies include excepted life policies (ELP) defined in subsection 393B(4) of the Income Tax (Earnings and Pensions) Act 2003 ('ITEPA') and are generally set up for one, or a small number of directors (when the arrangement will be known as an Excepted Group Life Scheme - EGLS). These policies trace their origins back to 1989 when the £60,000 earnings cap was introduced: premiums for benefits based on earnings above that level could not be paid to approved pensions and life assurance. The use of unapproved schemes was explored and they were used in a limited way: but an unintended consequence of that was that if there was more than one death under a policy the second death triggered a tax charge under the life assurance policy qualifying rules The 2003 Budget recognised this and the Income Tax (Trading and Other Income) Act 2005 followed (see below). This legislation permitted the establishment of life cover outside the approved, later registered, relevant benefit regime.

While ELPs/EGLSs might not normally benefit from special underwriting terms such the Free Limit which applies under larger group policies, provided the benefits are not excessive the employer can obtain expenses relief for Corporation Tax.Thus:

- these arrangements can enable allow employers to offer tax-efficient lump sum death-in-service benefits that do not count towards the Lifetime Allowance and avoid the 55% tax charge: EGLSs and ELPs are not registered pension schemes;
- premiums paid by the employer receive tax relief as they can be treated as business expenditure, provided that HMRC (the District Inspector) considers them wholly and exclusively for the purpose of trade as part of the remuneration of the individual (excessive benefits and premiums could fall foul of this requirement but is likely that provision of benefits within the old pre-2006 limits of 4x remuneration, lump sum, and 4/9ths remuneration, dependants'/spouse's income equivalent would be accepted. Besides higher benefits than theses might prove difficult for providers to underwrite and re-insure);
- premiums paid were not normally treated as benefits-in-kind on the employee though from 6 April 2017 contributions to an Excepted Life Arrangement are regarded as a benefit in kind for tax and NI purposes where funded through a salary sacrifice arrangement.

To qualify as an ELP, certain conditions arising from the Income Tax (Trading and Other Income) Act 2005 ss480/2 must be met:

- lump-sum benefits can only be paid for deaths before the age of 75;
- all members must have the same benefit formula;
- if the policy is cancelled it must not have a cash value and only unused premiums may be refunded;
- benefits must be set out in the policy;
- only lump sums can be paid;
- only individuals, charities and trusts set up for individuals may receive a benefit, not other insured persons unless they are a dependant or relative of the deceased; and
- the ELP must not be used for the main purpose of tax avoidance.

ELPs are particularly useful for clients who are close to the Lifetime Allowance limit: proceeds are not part of the Lifetime Allowance and therefore do not bear a 55% LA charge. ELPs are also useful for clients, or employees of corporate clients, with transitional protection from the Lifetime Allowance.

Benefits are paid under discretionary trust. While legal advice and care is needed to avoid 10 year charges and exit charges which would arise in discretionary trusts used the benefits can generally be paid to a key employee's dependants free of IHT.

2.3 CRITICAL ILLNESS COVER

The term Critical Illness covers a number of defined medical conditions which can be insured against either through an individual policy or through a group policy for employees of an employer or partners within a partnership. The cover provides for a lump sum benefit to be paid to an insured person who suffers one of the Critical Illness claim events listed under the policy. For those claims which arise from medical conditions, the date of the event is the date that formal diagnosis is made; for surgical procedures, the date is the date of actually undergoing the procedure. The individual/employee, spouse/registered civil partner or child, as appropriate, must survive a period of time that the insurer stipulates from the Critical Illness event (say, 30 days), after which the claim will be processed.

For group schemes, the policy will have eligibility conditions which the insured person must satisfy and he or she must meet the definition of being actively at work.

Benefit may be provided as a fixed amount or as a multiple of earnings. Normally, the maximum benefit payable per employee is four times earnings to a maximum of £500,000, or £250,000 with no salary based limitations.

For group schemes, there are two types of cover available, Base and Extra (otherwise known as Core and Additional) Cover. Base cover provides cover for some of the most serious Critical Illness events (such as Cancer, Heart attack, Kidney failure, Stroke), where Extra cover insures all the conditions listed under Base cover plus a wide range of additional Critical Illness events (such as Coma, Heart surgery, Blindness, Deafness).

Depending on the size of the scheme membership in a group policy, a level of medical evidence free cover will be available known as the Automatic Entry Level (AEL). The AEL is a level of benefit which will normally be granted to an individual regardless of their state of health provided they are otherwise eligible to become a member, subject to the pre-existing conditions exclusion. Under the pre-existing conditions exclusion, a member will not be able to claim for a Critical Illness event, which they have previously experienced even though that Critical Illness event would otherwise have met the definition under the policy. Also certain Critical Illness events rule out other Critical Illness events – e.g. a member who suffered a heart attack before joining the policy would not be able to claim for a subsequent heart attack event under the policy. If an employee's benefit entitlement exceeds the AEL they will need to provide medical evidence: the insurer may agree that full cover (i.e. including the otherwise-excluded condition) can be considered.

Note that the AEL is not identical to the Free Cover limit described earlier. With an AEL the insurer will pay more attention to pre-existing conditions in the event of a claim.

Taxation issues

Under a group policy, the whole cost of a standard Critical Illness policy is usually met by the employer. Premiums paid by the Policyholder (i.e. the employer) to insure employees against Group Critical Illness events are a trading expense and can be offset against Corporation Tax. The employer is liable for Class 1A National Insurance Contributions on the premiums.

The employee is taxed on the amount of the premium paid on their behalf by their employer as a benefit in kind (unless employee is outside the scope of P11D). Benefits are paid to the member tax free.

2.4 PERSONAL ACCIDENT INSURANCE

Where provision is made by the employer benefits may be either on a fixed scale or salary related. In the latter instance cover will be expressed as a multiple of salary in the event of accidental death or Permanent Total Disability (PTD) with proportionate sums payable in the event of loss of limbs etc.

With regard to schemes involving voluntary membership it is usual for a range of benefit level options to be available which may be expressed as fixed scales or as units of benefit with the employee choosing how many he wishes to purchase.

A typical scale of benefit might be for example:

Permanent Total Disability	£100,000
Loss of sight in one or both eyes or loss of use of arm, hand or leg above the knee	£100,000
Loss of hearing in both ears	£40,000
Loss of hearing in one ear	£10,000
Loss of use of:	
A leg below the knee or a foot	£50,000
A shoulder or elbow	£25,000
A hip, ankle, knee, wrist, or a thumb	£20,000
Any finger or big toe	£10,000
Any other toe	£5,000
Accidental death	£50,000
Hospital Cash Benefit payable for up to 104 weeks	£100 per day
Home convalescence Benefit after at least seven days in hospital, for up to four weeks.	£400 per week

The cost of such a benefit scale will depend on the occupation class of the group to whom cover is being offered and may be set up on an employee only basis, employee and spouse, or for full family cover with the cost adjusted accordingly.

2.4.1 Benefit Restrictions

All of the events described in the above scale of benefits which may lead to a claim are in any event subject to the definitions contained in the policy documentation.

For example, Permanent Total Disablement (PTD) may be defined as "the policyholder's inability to perform or give attention to each and every duty of his or her occupation". In more easily understandable terms, another possible definition might be "disablement caused other than by loss of limb or eye which having lasted for at least 12 months will in all probability entirely prevent the employee from engaging in his or her usual occupation for the remainder of his or her life". Less strict definitions will generally be applied in respect of a spouse or children, where covered, which may refer to "any occupation for which he or she is fitted by reason of education, training or experience", but again the disability must by definition be of a permanent nature.

There are in addition specific exclusions which may apply. For example benefits may not be payable in respect of bodily injury as a result of:

- suicide or self-inflicted injury
- war and kindred risks
- full time military service
- flying as a pilot or aircrew.

It is usual for cover taken out by an individual to be provided without restriction, i.e. 24 hours a day and worldwide.

However when cover is provided by the employer, it may be that cover is only available whilst the employee is engaged on business on behalf of his employer. Such cover will be provided automatically for the employee by the employer. Schemes which do not impose such a restriction may be either automatic or voluntary, which in effect means either totally employer funded or merely the availability of a scheme which the employee may choose to join and if so at a cost which because of the operation of group terms will be highly competitive.

2.4.2 Tax Treatment

Where the cost of cover under a Personal Accident scheme is met by the employer, the premium will be taxable on the employee as a benefit in kind. Benefit payments are however tax free in the event of a claim, except for sickness benefits which are taxable. The premiums are allowable for tax as a business expense to the employer; Class 1A NI contributions are payable.

Where the scheme is voluntary, contributions will generally be collected from the employee by direct deduction from pay however there is no relief against income tax, and benefits are tax free.

2.5 KEYPERSON COVER

Many businesses fail to protect themselves from the financial consequences of one or more of their most important assets, namely the key people that they employ. Keyperson insurance is designed to protect the company that purchases the cover from losses arising from the loss of the services of key individuals connected with the company due to accident or sickness. Such cover is occasionally known as "Economic Death Insurance". Another issue that may require protection is where a business has borrowed to support a particular project or tends to rely on a substantial overdraft for the purposes of day to day trading.

The cover may be in respect of disablement or death and such cover may be purchased individually or as part of a package that covers death, disablement and critical illness.

There are many possible examples of people who may be key:

- A shareholder director who might be central to a small business.
- A sales director where personal contact with key customers might be central to their ongoing support.
- Specialist technical personnel who are for example involved in a key new product development. It is possible to clearly envisage this for example in fast growing information technology or biotechnology companies.
- A Project Manager whose control and input may be vital in the successful completion of a civil engineering project for example where any time overruns due to the loss of this key resource may involve crippling financial penalties.

2.5.1 Sum Insured

The Sum Insured must represent the proven value of the individual, and may be related to the company's turnover or profits or may in some way be linked to the individual's contract of employment or some other contract in which the individual's continued involvement is vital. Sums insured will always be substantial and cover of up to £25 million per person is readily available in the market. Depending on the level of cover increasing degrees of medical information will be required for underwriting purposes. Financial underwriting will also be necessary, to show that the Sum Insured is reasonable in relation to the loss to the business resulting from the key person's death or disability.

If the key person frequently travels abroad on the business of the employer, extra cover against accidental death and/or sickness may be arranged to give additional protection to the individual and his family for the duration of the trip.

252 Taxation Position

The taxation position is not entirely clear because there is no legislation in place.The Inland Revenue's District Inspectors have always had discretion in granting tax relief on premiums and determining how the receipt of claims monies should be treated in the company's hands.The principles of the taxation of Keyperson premiums and claims arise out of a written answer to a Parliamentary question, as long ago as 1944, given by Sir John Anderson, the then Chancellor of the Exchequer. It is worthwhile quoting the relevant extract as follows:

"the general practice in dealing with Insurances by employers on the lives of the employees is to treat the premiums as admissible deductions, and any sums received under a policy as trading receipts if:

(i) the sole relationship is that of employer and employee
(ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee, and
(iii) it is an annual or short term* insurance. Cases of premiums paid by Companies to insure the lives of Directors are dealt with on similar lines".

* short-term is generally taken to mean no more than five years

In accordance with the Anderson Principles, tax relief should be granted on Keyperson insurance premiums and the proceeds in the event of a claim will be treated as a trading receipt if the above three conditions are satisfied.

The detailed treatment of a particular case depends upon both the circumstances and the practice of the company's local Inspector of Taxes.

If any other kind of policy is used, such as a Whole of Life policy, then generally tax relief would not be expected on the premium and HMRC would not seek to tax the proceeds. Whole of life assurance could be used where shareholder protection Keyperson insurance is required. Here the objective would not only be to insure the possibility that the services of a key person could be lost but also to provide the means specifically to buy out a retiring partner's share of the business in the event of retirement.. Shareholder protection insurance needs additional consideration at the policy documentation stage. Whereas for the Keyperson insurance discussed earlier in the section is taken out by the company, Shareholder and partnership insurance needs to consider not only who is paying the premiums but also who should receive the monies in the event of death. In this more complex form of Keyperson insurance trusts will generally be used. For example a partner may take out a policy on his own life and then assign that policy into trust for the benefit of his partners so that his share of the partnership could be bought from his widow in the event of his untimely death. Life-of-another policies can also be used but they can be unwieldy in all but small partnerships.

2.6 HEALTH CARE SCHEMES

Medical Expenses insurance or Private Medical Insurance (PMI) is intended to provide for medical expenses incurred during acute illness or injury. These costs can include surgical operations, consultations, diagnostic investigations and procedures such as blood tests and scans. These can be received either as an in-patient, day care patient or as an out-patient. Generally, unless the private medical insurance scheme is very large, has bespoke benefits and quite possibly claims-related premiums, chronic conditions are not covered. Chronic conditions may involve treatment of a long-standing problem, e.g. back complaint; or ongoing issues, arising from what was once an acute illness or injury could begin to be treated as chronic by the insurer.

This insurance does not usually provide for all health care to be provided privately. It is generally complementary to the NHS. Primary care (from the General Practitioner (GP) at the local doctors' surgery), normal childbirth and maternity care, accident and emergency, intensive care and chronic conditions are almost exclusively provided by the NHS. It is not the purpose of private medical insurance cover to deal with routine matters that can be readily dealt with by the individual's GP. It is the role of the GP to determine the extent of and whether specialist care or an operation is required, and for a valid claim it will be normally be necessary for the patient to have been referred by his or her own doctor.

An employer who includes private medical care as a benefit usually has the following objectives:

- attracting and retaining employees
- minimising absence
- increasing productivity.

26.1 PMI Benefits Generally Provided

A standard Health Care Scheme or PMI contract will refund, perhaps up to stated limits, the following:

- ***In Patient Hospital Charges*** including: nursing, accommodation. Operating theatre fees, prostheses, surgical dressings. drugs, and private ambulance (where medically necessary)
- ***In Patient Surgical and Medical Charges*** including: surgeons' fees, anaesthetists' fees, physicians' fees, radiotherapists' fees, consultation charges, pathology, radiology, scans (MRI, CT or PET), radiotherapy, chemotherapy, biological therapy and physiotherapy
- ***Out Patient Charges*** including: consultations, pathology, radiology, scans, radiotherapy, chemotherapy, biological therapy and physiotherapy
- ***Home Nursing Charges*** – these are in practice rare since the nursing care must be both medically necessary on a continuous basis and under the supervision of a specialist. If paid it is usually for a limited period.

Cover is generally provided for emergency treatment received overseas and inevitably shortfalls will occur, as benefit levels are designed to meet the cost of treatment in the UK. If treatment is received in the US in particular, significant shortfalls will be experienced. Benefit is not provided if the plan member explicitly travels overseas to receive treatment. With all plans it is necessary to obtain the authorisation of the insurer before treatment is received. Evacuation and Repatriation may also be covered: Evacuation means transport of a patient to the nearest suitable medical establishment for treatment, while Repatriation means transport home, including Repatriation of mortal remains.

26.2 Levels of Cover and How Cover is Costed

It is common to offer different levels of cover that attract different premium rates. One provider, for example, has three levels of hospital category – A, B and C, with A being the most expensive and C the cheapest. Each hospital will fall into one or more of these categories. Some hospitals might only have rooms at level A, whereas others could have three different types of rooms at levels A, B and C. These categories refer to the standard of hospital accommodation: the insured medical care is provided regardless of category, though the amount paid per claim or policy year may be limited by other policy terms including those selected by the policyholder.

However, some of the insurers have now developed "Networks" whereby the benefits and premiums are not based on hospital category and cover hospitals UK wide. The insurer may have also negotiated agreements with hospitals to limit the costs per treatment.

There may be a simple full recovery of fees where usually the insurer pays the hospital fees direct. Some providers may impose a maximum benefit that may be claimed in a policy year, e.g. £50,000. Other providers include the option for the policyholder or in the case of a group scheme the member, to pay the first (say) £100 in the event of a claim. This is called an excess and its inclusion has the effect of reducing the premiums. A choice of a scale of excesses is available. One insurer also has a "Shared Responsibility" scheme. It works like an excess but the policyholder will pay 25% of the cost of all claims up to an agreed limit above which the insurer meets the whole cost.

In relation to group schemes insurers calculate the cost based on a number of factors including the scale of cover chosen, the type of the client's business, its location, the age of the employees covered, whether any family members are included, the underwriting process agreed (see below) and any excess adopted.

Consideration is also given to the hospitals that can be used – e.g. network scale (a limited list restricting choice), A, B or C scale etc.

Company paid schemes can be either Community Rated or Experience Rated (for 50 plus members, though some insurers will look at the claims experience of significantly smaller schemes).

Community Rated

The most important aspect of these schemes is that the premiums for each member is based on the member's age (or age band where the insurer looks at rates in quinquennial bands) and these premiums are based on the insurer's claims experience for that entire book of business. The insurers tend to have various pools reflecting low to high claiming groups and therefore different rate tables to reflect this. Statistical evidence shows that certain locations and industries present a higher or lower risk – with the cost therefore varying accordingly.The benefit of this approach is that the quoted cost price accurately reflects the expected claims of an individual company and hopefully provides future premium stability. This type of private medical insurance scheme is normally best suited to groups that include up to 50 employees (plus dependants).

Experience Rated

Premiums are based on the claims experience of the membership of that particular group and the premiums for the members will be the same regardless of the member's age (except in the case of any pensioners that may be included where the premiums could be considerably higher). This can be an attractive option where there are a large number of members in a group (normally 50 or more employees plus dependants) – in effect forming their own community.This enables the insurer to charge a premium based upon the expected level of claims for the group in question.The insurer will invite the appointment of a Group Secretary at the client company and since this person is often the Finance Director or someone close to the Finance department, there is an incentive for the company to take a close interest in claims management: if they do not their premiums could increase.

263 Policy Exclusions

Not all treatments are covered under a PMI scheme. Except for large employer paid group plans, the norm is that members are not covered for known pre-existing medical conditions at the time of joining. Other exclusions found in the market place vary between PMI providers who may for example exclude:

- optical care
- routine dentistry (although "oral surgery" may be included i.e. removal of impacted wisdom teeth)
- routine maternity care (although "specified obstetric procedures" may be included such as necessary Caesarean Sections)
- prophylactic surgery
- primary care (GPs)
- chiropody
- psychotherapy
- alcohol and drug abuse related conditions
- geriatric care
- cosmetic surgery (unless it is an integral part of a surgical procedure that is covered)
- long term psychiatric care
- chronic medical conditions
- alternative medicine – such as Homeopathy, (although some PMI policies will allow alternative treatments if they are recognised by the British Medical Association).

Depending on the insurer and on policyholder requirements some of these exclusions can be overridden and included in the Medical Expenses package. Large group schemes may be designed with very wide cover in mind, though ultimately this will be paid for by the employer in the way premiums are calculated. (See also section 2.6.8 below.)

264 Main Categories of Medical Expenses Insurance Schemes

There are four main categories of medical expenses insurance schemes:

- Individual Purchase Plans
- Affinity Group Plans
- Voluntary Group Plans
- Company Paid Plans.

The market is split approximately 25% Individual Purchase Plans and 75% Group Plans. Affinity Group Plans are those set up to cover diverse groups of people such as trade unions, credit card holders and members of professional bodies. Voluntary Group Plans are company plans where the employee pays all or part of the premium. Where a Company Paid plan is only available for employees, a Voluntary Group Plan for dependants is often run alongside the Company Paid plan or the dependants can be added to the Company Paid plan and the subscription costs deducted from the employees pay.

Medical expenses cover falls into three main areas: Fully Insured, Cost Plus and Self-Insured.

Fully Insured

At the beginning of the contract period a premium rate is agreed and this is paid regardless of the actual claims experience of the group over the contract year. At the end of the year, the claims incurred and paid are considered and the following year's premium will be based on that experience. Most schemes for companies with less than 50 members, say, will be run on the standard fully insured basis.

Fully Insured plans are also available with a Profit Share or Risk Share element. Under Profit Sharing schemes, at the end of the year the insurer will compare the actual amount of claims with the premium paid. If the claims are lower than the claims fund, the difference will be repaid either in full, or an agreed percentage (say 50%), depending on the contract. If the claims are higher, no action is taken to obtain the deficit, but the insurer will obviously take into account that claims experience when calculating future premiums. Some insurers will only pay a profit share if the scheme renews with that insurer. Risk Sharing works in the same way as Profit Sharing, but with the insured paying any deficit up to a stated upper stop loss level (say 120% of the claims fund), and receiving any surplus to a stated lower stop loss level (say 80% of the claims fund).

Cost Plus

This is a similar concept to risk sharing above, but rather than a proportion of the surplus/deficit being refunded/paid the whole amount is refunded/paid. The plan will have an aggregate stop loss level set that limits the policyholder's liability (say 120% of the claims fund) and the insured will only be liable for the cost of claims up to that level during the contract year.

Self-Insurance

The employer pays for all claims. In order to do this a health trust must be set up which has to be approved by the local HMRC tax inspector. The employer can focus on the services being bought and their price, and will retain the investment earnings on the funds that would have been paid as a premium, funds that for some companies can run into millions of pounds. Administration can still be carried out by an insurer. Insurance Premium Tax (IPT) does not apply to self-insured plans, but Value Added Tax is applied to the administration

charges. Should the health trust purchase aggregate stop loss insurance or specific stop loss insurance, IPT is applicable to the stop loss premium. Specific stop loss insurance limits the claim liability in respect of any individual member of the trust to a specific financial limit in a scheme year (£35,000 or £50,000 for example).

26.5 Tax Treatment

Individual Plan

The premium is usually paid from income from which tax and NI contributions have already been deducted. Despite the removal of income tax relief on policies for the over 60s, many providers still offer specialist policies to deal with the specific needs of those over retirement age.

Insurance Premium Tax (IPT)

Since 1 October 1994 IPT has been levied on medical expenses insurance policies. The standard rate, which applies to PMI schemes, was originally set at 2.5% but increased to 5% from 1 July 1999, increased again to 6% on 4 January 2011, to 9.5% with effect from 1November 2015 (or 1March 2016 in a few cases where prior accounting agreements have already been made), 10% on 1 October 2016 and again to 12% on 1 June 2017. The contributions made to a self-insured trust fund are not subjected to IPT where contributions are met by the employer, except in respect of any stop loss insurance.

Value Added Tax (VAT)

With private healthcare schemes, VAT only applies to the administration charges of a Healthcare Trust.

Group Plans

These incur a benefit in kind charge on the premium paid by the employer on his behalf. They are not liable to tax or NI on the cost of the treatment. If they pay any part of the premium themselves, it is treated as for an Individual Plan above.

The employer receives tax relief on its premiums – they are treated as an allowable business expense. There is no tax or NI liability in respect of any employee premiums or the cost of medical treatment.

26.6 Controlling Costs

In recent years, there has been a significant increase in claim costs and hence premium rates. Much of this increase can be attributed to increasingly complicated (and advanced) medical treatment and the use of very expensive newly-developed drugs: this is on top of general inflationary increase. Consequently clients and insurers constantly look out for ways to limit the increases. This has led to a new range of products with reduced benefits, and/or incentives, to encourage lower claim costs (consider the use of "Shared Responsibility" referred to above and excesses discussed further below).

Managed Care

Insurers require the claimant to contact a helpline before treatment takes place.The insurer then has an opportunity to be proactive in routing the individual to the most cost effective course of treatment.This may involve:

- routing to NHS/lower cost private hospital
- routing to day care rather than in-patient care
- pre authorisation and concurrent review of long in-patient stays, particularly for psychiatric conditions
- provision of non-standard benefits, e.g. wheel chair ramps, taxi fares etc. if these will allow early discharge from hospital and are cost effective
- provision of second opinions if initial diagnosis recommends expensive surgery.

Directional Care

A recent development in cost containment that is beginning to become popular is "directional care". This is a practice whereby, either by the terms and conditions of the private medical insurance scheme (compulsory) or via the Managed Care process (optional), members have to, or are encouraged to use "preferred suppliers" for their private treatment.

Deferred Access Plans

The eligibility for the benefit depends on the length of the waiting list for the treatment under the NHS. Usually there would have to be a wait of six weeks or more under the NHS before private treatment would be covered. This has been more popular in the individual policy market.

Excesses

Excesses are a common feature of motor and household insurance, and have been extended to medical insurance for some time. This is where the first part of a claim is paid by the insured. Excesses can be on either "a per claim basis" (e.g.£50 per claim) or a "claims per person per year basis" (e.g.£100 per year), and result in a lower premium.

The effect on the premium is typically a 5% saving for an excess of £100 per person per annum.

Including compulsory excess on out-patient claims reduces the number of small claims, which make up a large proportion of the total number of claims and hence a large proportion of administration costs. The cost of administering a claim varies little with size. Hence small claims cost a disproportionately large amount when compared to larger ones.

However, current thinking is that it is not always desirable to create a barrier to receiving private treatment from a private medical insurance scheme. This is because it could lead to increased sickness absence costs and/or medical conditions remaining untreated leading to serious consequences.

Co-insurance

This would take the form of, for example, the insured meeting 10% of the cost (say subject to a maximum of £1,000) and the insurer meeting the other 90%. It both discourages unnecessary use of treatment and encourages the insured to seek the lowest cost treatment available. This approach could be expected to reduce the premium by around 8%. This cost saving method is not common in the UK and not all insurers are able to administer it. An example of Co-insurance is the Shared Responsibility approach mentioned above.

No Claims Discount

This concept in medical expenses insurance operates in a similar fashion to motor insurance, which applies to Individual rather than Group Plans. Each year of no claims results in a further discount applied to the premium, for example:

Year 1	No discount
Year 2	20% discount
Year 3	30% discount
Year 4 onwards	40% discount

26.7 Eligibility and Costs

Individual plans, small company paid plans and small voluntary group plans will usually be individually underwritten, i.e. using questionnaires or a moratorium. Employers with larger plans, say over 20 employees, will usually be able to negotiate nil, or much reduced, medical underwriting requirements and this may include cover for pre-existing conditions. This is termed "Medical History Disregarded" or MHD. In return, the insurer will insist that the plan covers all employees in a defined category, i.e. the company cannot just insure the "bad risks".

Full Medical Underwriting (FMU)

This is where applicants for medical insurance have to complete a detailed questionnaire that is designed to find out whether any medical conditions are already present. Applicants with pre-existing conditions will usually be accepted for insurance, but treatment for those conditions will usually be excluded. If the policyholder then develops a condition of which they were not aware at the time of purchasing the insurance, they will be covered. A discount on the premium may be offered by the insurer where FMU has been completed.

Moratorium

With this method applicants are not required to make any declaration of their health history, but a blanket exclusion is placed on their membership detailing that they will be excluded from treatment of any pre-existing medical condition that they were aware of, or have had treatment for in the five years prior to application, for a period of two years (or longer). Should they have treatment or seek advice for these conditions in the two-year period, this period will extend indefinitely until they have gone for two full years without any treatment or advice for these conditions. This method however has become less used. In the late 1990s the Office of Fair Trading commented on the use of this practice and in their May 1998 Second Report re-stated their "conclusion that consumers failed to understand the implications of moratorium underwriting" and "its potentially adverse implications".

Scheme Transfers

If a member transfers from one scheme to another, or an entire scheme transfers from one insurer to another, it may be possible to do this on a "Continued Personal Medical Exclusions" (CPME) or "No Worse Terms" (NWT) basis. This means that the member(s) will not be subject to new underwriting, but carry any existing exclusions with them to the new scheme.

268 Other Design Features

Other features often included in a policy are:

- NHS Cash Benefit
- Employee Contributions
- Psychiatric and Addictive Conditions
- Maternity Cash Benefit or Baby Benefit
- Dental Treatment.

NHS Cash Benefit

This is paid when NHS public facilities are used, and is designed to cover out of pocket expenses when using the NHS and act as an incentive to use the NHS when adequate treatment is available. A typical amount might be £100 per night.

Employee Contributions

Most employers pay the premiums, but it is of course possible to introduce employee contributions (on which no tax relief is available). They could, for example, be introduced just for the cost of the dependants' benefit.

Psychiatric and Addictive Conditions

Psychiatric benefit is an area that can be abused and some companies are moving to restrict benefits here by reducing the number of days for which the benefit is paid. Typically, 28 in-patient nights per benefit year is the norm. Some insurers provide an annual maximum of £10,000 per benefit year for all in-patient and out-patient treatment.

Maternity Cash Benefit or Baby Benefit

This benefit is a cash sum (usually £100) payable on the birth of a child. This benefit would normally only be payable if the member had been covered by the plan for a minimum of 12 months.

Dental Treatment
Apart from serious acute dental conditions, the costs of dental treatment are not included in PMI policies. Routine dental treatment can be insured though this is normally provided under a separate policy.

269 International Private Medical Insurance
This insurance is for expatriates, or third country nationals working on an expatriate employment contract outside of their country of domicile. The plans provide the same benefits as UK Private Medical Insurance plans, except they tend to offer full refunds with annual claims limits of typically £1 million.

Chronic conditions are typically covered, and options are available to cover primary care, routine dentistry and maternity. Medical evacuation by air ambulance is provided where treatment is not available in the location where an expatriate may be working, to either their country of domicile or the nearest country where suitable treatment can be received.

Typically there are three levels of cover, Europe, Worldwide excluding the USA, and Worldwide.

24/7 Helplines are provided to enable members to authorise treatment, and to obtain general health advice and information.

Plans are available for individual purchase and employer group plans.

27 PAYMENT PROTECTION INSURANCE

Payment Protection Insurance (PPI) is a form of insurance that an individual might purchase to cover the cost of a loan (and debt from credit agreements) if they cannot meet the repayments for some reason, such as falling ill or being made redundant. One of the most common forms of PPI is mortgage payment protection insurance, which covers the cost of the policyholder's mortgage repayments should they be unable to repay the loan.

In recent years there have been a number of customer complaints about PPI products that they have been sold. This has led to the FCA (then the FSA) issuing the following advice to be followed when selling these policies:

- Ensure the customer is told that PPI is optional, where this is the case.
- Ensure the customer is given clear information about the product and what it will cost.
- Ensure the customer is given the assistance they need to be clear about what they are eligible for under the policy and what the exclusions are.
- Where advice is given, ensure the customer is recommended a policy that meets their needs.
- Ensure the customer is offered a fair refund if they cancel their policy.

28 LONG TERM CARE

State benefits can provide some help when a person needs daily assistance, but this may not be enough or may not pay for the full cost of long term care. The level of State support you receive is different depending on whether you live in England, Wales, Scotland or Northern Ireland. In England and Wales means-tested state assistance is available but if savings and assets are above £23,250 in England (slightly higher figures for Wales and Scotland) the full cost of long term care needs to be self-funded. A sliding scale starts at £14,250 where part of capital between £14,250 and £23,250 is regarded as producing income which is taken into account in assessing needs. The Government are planning to amend the provision of long-term care benefits following the 2011 report of the Dilnot Commission. The original intention to increase the £23,250 means-tested threshold to

£123,000 has been trimmed back to £100,000 (and now includes the value of a person's home) while the planned introduction in 2020 of an overall cap of £72,000 on nursing costs has been abandoned, although "clarifications" made by Theresa May following the unpopular "dementia tax" proposals in the 2017 Tory Manifesto suggest that an overall cap may be back on the agenda.

Long-term care insurance helps provide for the cost of long-term care beyond a predetermined period. It may be domiciliary, given at home, or residential depending on a person's needs and circumstances. Long-term care insurance covers care generally not covered by health insurance. It will generally cover home care, assisted living, adult day care, respite care, hospice care, nursing home and Alzheimer's facilities. If home care coverage is purchased, long-term care insurance can pay for home care, often from the first day it is needed. It will pay for a visiting or live-in caregiver, companion, housekeeper, therapist or private duty nurse up to seven days a week, 24 hours a day (up to the policy benefit maximum). Pre-funded plans gave the option of insuring future care needs before they develop but these plans are no longer available.

In many ways long-term care provision is now reactive because of the substantial and growing costs of the service which have made pre-funded cover so difficult to underwrite. Following the Care Act 2014, some people in need of care may be able to agree a deferred payment arrangement for their care, meaning that the local authority funds care costs which are later repaid from the sale of their home. Annuities, possibly enhanced because of impaired health and investment of assets for income can defray the costs of care and nursing home fees and it is in these areas that advice can now productively be given. But the use of annuities for this need will be impacted by a client's choice to surrender all their funds under pensions freedom: on the other hand for SIPPs and SSASs, the capital under those schemes can now be flexibly accessed and perhaps used for long-term care.

29 INDIVIDUAL POLICIES

Many protection benefits which clients enjoy emanate from policies funded by their employer. The previous sections in this Chapter have considered them in detail and referred where appropriate to individual policies. Where such policies and benefits exist it is generally sensible to recommend that they continue.They will have been set up on group terms conferring significant advantages in terms of cost, probably in terms of tax treatment and in terms of benefits provided free of evidence of health. Whether or not the adviser's recommendation is that these policies should continue (or otherwise), it is very important that the adviser is aware of their existence.

Similarly the adviser should check with his client whether any personal policies exist. If there are and they were taken out some years ago, it is possible and indeed probable, that the terms of these older contracts are better than terms currently available. For example a PHI policy taken out by a client, say 15 years ago when he was in his 20s, will be a lot cheaper per £1 of benefit than a similar policy starting now. The rates would have been fixed (probably) 15 years earlier being based on the age of someone 15 years younger.There may be health issues: if over the 15 years the client's health has deteriorated then a medical loading could be added to the premium or even an exclusion applied. While it is likely that such a policy would no longer provide adequate benefits overall, there is nothing to stop it remaining in situ and forming a base around which to build supplementary benefits. Further the 15-year-old policy may have valuable increase options.

Summary

In Chapter 3 we looked at Permanent Health Insurance and Private Medical Insurance arrangements, the providers of such arrangements, and the key features and benefits of them. We considered the scope of the cover available in such schemes, and, how these schemes are costed.

We have considered some of the design features of Critical Illness benefits that are available to employees through an employer arrangement and Keyperson cover.

We have also dealt with:

- benefits provided under personal accident and sickness schemes
- benefit restrictions
- tax treatment of benefits
- tax treatment of contributions.

Finally we considered PPI and long-term care.

Self Test Questions

- List the key features associated with an income protection insurance arrangement.
- Summarise the tax treatment of benefits and contributions under an income protection insurance scheme.
- List the objectives that are typical of an employer in providing a private medical care scheme.
- List six typical exclusions associated with group PMI policies.
- What is the purpose of Keyperson insurance and on what basis would the Sum Insured be calculated?
- What main benefits are payable under a Personal Accident and Sickness scheme?
- What taxation differences are there to the individual for employer paid and voluntary Personal Accident and sickness schemes?
- Describe the two types of cover which can be provided under a Critical Illness scheme.
- Summarise the tax treatment of benefits under a Critical Illness insurance scheme.

PERSONAL TAX AND BENEFITS

Powers to vary the tax rates and thresholds of Non-Savings, Non-Dividend income for Scottish taxpayers were devolved to the Scottish Parliament in April 2017.The income tax personal allowance and all other elements of the income tax system remain reserved.

Income tax bands of taxable income (£ per year)

	Tax year 2018-2019	Tax year 2018-2019
Basic rate	£0-34,500	£0-34,500
Higher rate	£34,501-150,000	£34,501-150,000
Additional rate	Over £150,000	Over £150,000

Income tax rates – 2017 to 2018

Main rates [1]	**Tax year 2018-19**
Basic rate	20%
Higher rate	40%
Additional rate	45%
Savings rates [2]	
Starting rate for savings	0%
Savings basic rate	20%
Savings higher rate	40%
Savings additional rate	45%
Dividend rates [3]	
Dividend ordinary rate - for dividends otherwise taxable at the basic rate	7.5%
Dividend upper rate - for dividends otherwise taxable at the higher rate	32.5%
Dividend additional rate - for dividends otherwise taxable at the additional rate	38.1%
Default rates [4]	
Default basic rate	20%
Default higher rate	40%
Default additional rate	45%

Income tax rates - 2018 to 2019

Main rates [5]	**Tax year 2019-20**
Basic rate	20%
Higher rate	40%
Additional rate	45%
Savings rates [6]	
Starting rate for savings	0%
Savings basic rate	20%
Savings higher rate	40%
Savings additional rate	45%
Dividend rates [7]	
Dividend ordinary rate - for dividends otherwise taxable at the basic rate	7.5%
Dividend upper rate - for dividends otherwise taxable at the higher rate	32.5%
Dividend additional rate - for dividends otherwise taxable at the additional rate	38.1%

Income tax rates - 2018 to 2019

Default rates [8]	**Tax year 2018-19**
Default basic rate	20%
Default higher rate	40%
Default additional rate	45%

Starting rates for savings income

	Tax year 2018-2019	**Tax year 2019-2020**
Starting rate for savings	0%	0%
Starting rate limit for savings	£5,000	£5,000

Special rates for trustees' income

	Tax year 2018-2019	**Tax year 2019-2020**
Standard rate on first £1,000 of income which would otherwise be taxable at the special rates for trustees	Up to 20%, depends on the type of income	Up to 20%, depends on the type of income
Trust rate	45%	45%
Dividend trust rate	38.1%	38.1%

Income tax allowances

	Tax year 2018-2019	**Tax year 2019-2020**
Personal allowance		
Personal allowance [9]	£11,850	£12,500
Income limit for personal allowance	£100,000	£100,000
Income limit for Married couple's allowance 1[0]	£28,900	£29,600
Marriage allowance [11]	£1,150	£1,250
Married couple's allowance for those born before 6 April 1935:		
Maximum amount of married couple's allowance [12]	£8,695	£8,915
Minimum amount of married couple's allowance [12]	£3,360	£3,450
Blind person's allowance	£2,390	£2,450
Dividend allowance	£2,000	£2,000
Personal savings allowance		
Personal savings allowance for basic rate taxpayers	£1,000	£1,000
Personal savings allowance for higher rate taxpayers	£500	£500

NATIONAL INSURANCE CONTRIBUTIONS (NICs)

Class 1 NICs: Employee and employer rates and thresholds and allowance (£ per week – except where stated)

	Tax year 2018-2019	**Tax year 2019-2020**
Weekly Lower Earnings Limit (LEL)	£116	£118
Weekly Primary Threshold (PT)	£162	£166
Weekly Secondary Threshold (ST) 13	£162	£166
Upper Earnings Limit (UEL) 14	£896	£962
Employment Allowance (per employer)	£3,000 per year	£3,000 per year

Employee's (primary) Class 1 contribution rates

	Tax year 2018-2019	Tax year 2019-2020
Earnings band	NIC rate	NIC rate
Below LEL	0%	0%
LEL - PT 15	0%	0%
PT- UEL	12%	12%
Above UEL	2%	2%

Married woman's reduced rate for (primary) Class 1 contribution rates

	Tax year 2018-2019	Tax year 2019-2020
Weekly earnings from between the PT and UEL	5.85%	5.85%
Weekly earnings above UEL	2%	2%

Employer's (secondary) Class 1 contribution rates

	Tax year 2018-2019	Tax year 2019-2020
Earnings band [13]		
Below ST	0%	0%
Above ST	13.8%	13.8%

Class 2 NICs: Self-employed rates and thresholds (£ per week)

	Tax year 2018-2019	Tax year 2019-2020
Small Profits Threshold (SPT)	£6,025 per year	£6,365 per year

Class 2 contribution rates

	Tax year 2018-2019	Tax year 2019-2020
Annual Profits (£ a year)	**£ per week**	**£ per week**
Below SPT [18]	£0	£0
Above SPT	£2.95	£3.00

Class 3 NICs: Other rates and thresholds (£ per week)

	Tax year 2018-2019	Tax year 2019-2020
Voluntary contributions [19]	£14.65	£15.00

Class 4 NICs: Self-employed rates and thresholds (£ per year)

	Tax year 2018-2019	Tax year 2019-2020
Lower Profits Limit (LPL)	£8,424	£8,424
Upper Profits Limit (UPL)	£46,350	£50,000

Class 4 contribution rates

	Tax year 2017-2018	Tax year 2018-2019
Annual profits band	NIC rate	NIC rate
Below LPL	0%	0%
LPL to UPL	9%	9%
Above UPL	2%	2%

WORKING AND CHILD TAX CREDITS, CHILD BENEFIT AND GUARDIANS ALLOWANCE

£ per year (unless stated)	Tax year 2018-2019	Tax year 2019-2020
Working tax credits		
Basic element	£1,960	£1,960
Couple and lone parent element	£2,010	£2,010
30 hour element	£810	£810
Disabled worker element	£3,000	£3,090
Severe disability element	£1,290	£1,330
Childcare element of the working tax credit		
Maximum eligible cost for one child	£175 per week	£175 per week
Maximum eligible cost for two or more children	£300 per week	£300 per week
Percentage of eligible costs covered	70%	70%
Child tax credit		
Family element	£545	£545
Child element	£2,780	£2,780
Disabled child element	£3,175	£3,275
Severely disabled child element	£4,600	£4,600
Income thresholds and withdrawal rates		
Income threshold	£6,420	£6,420
Withdrawal rate (per cent)	41%	41%
First threshold for those entitled to child tax credit only	£16,105	£16,105
Income rise disregard	£2,500	£2,500
Income fall disregard	£2,500	£2,500
Child benefit (£ per week)		
	Tax year 2018-19	**Tax year 2019-20**
Eldest/only child	£20.70	£20.70
Other children	£13.70	£13.70
Guardians allowance (£ per week)		
Guardians allowance	£17.20	£17.60
Tax free savings accounts		
	Tax year 2018-19	**Tax year 2019-20**
Individual Savings Account (ISA) subscription limit	£20,000, of which £4,000 can be saved into a Lifetime ISA	£20,000, of which £4,000 can be saved into a Lifetime ISA
Junior ISA subscription limit	£4,260	£4,368
Child Trust Fund (CTF) subscription limit	£4,260	£4,368

Capital Gains Tax

	Tax year 2018-19	Tax year 2019-20
Main rates for individuals	10% / 20%	10% / 20%
Rates for individuals (for gains on residential property not eligible for Private Residence Relief, and carried interest)	18% / 28%	18% / 28%
Main rate for trustees and personal representatives	20%	20%
Rate for trustees and personal representatives (for gains on residential property not eligible for Private Residence Relief)	28%	28%
Annual exempt amount (AEA) for individuals and personal representatives	£11,700	£12,000
AEA for most trustees	£5,850	£6,000
Rate on gains subject to entrepreneurs' relief	10%	10%
Rate on gains subject to investors' relief	10%	10%
Entrepreneurs' relief: lifetime limit on gains for entrepreneurs	£10,000,000	£10,000,000
Investors' relief: lifetime limit on gains for external investors	£10,000,000	£10,000,000

Inheritance Tax

	Tax year 2017-18	Tax year 2018-19
Rate (for estates)	40%	40%
Reduced rate (for estates leaving 10% or more to charity)	36%	36%
Rate (for chargeable lifetime transfers)	20%	20%
Nil rate band limit	£325,000	£325,000
Residence nil rate band limit	£100,000	£125,000

1. Apply to non-savings, non-dividend income, including earnings from employment, self-employment, pension income, foreign income, taxable benefits and income from property.
2. Apply to savings income.
3. Apply to dividend income above the £5,000 tax-free Dividend Allowance.
4. Apply to non-savings, non-dividend income.
5. Apply to non-savings, non-dividend income.
6. Apply to savings income.
7. Apply to dividend income above the £2,000 tax-free Dividend Allowance.
8. Apply to non-savings, non-dividend income.
9. The Personal Allowance reduces where the income is above £100,000 – by £1 for every £2 of income above the £100,000 limit.This reduction applies irrespective of date of birth.
10. This age-related allowance is reduced by £1 for every £2 of income over this limit.
11. This transferable allowance is available to married couples and civil partners who are not in receipt of married couple's allowance. A spouse or civil partner who is not liable to income tax; or not liable at the higher or additional rates, can transfer this amount of their unused personal allowance to their spouse or civil partner.The recipient must not be liable to income tax at the higher or additional rates.
12. The relief for this allowance is given at 10%.
13. Employers begin paying Employer's National Insurance Contributions above the Secondary Threshold.They pay a zero rate up to this point.
14. This threshold is uprated in line with the Income Tax Higher Rate Threshold to maintain alignment.
15. No National Insurance contributions (NICs) are actually payable but a notional Class 1 NIC is deemed to have been paid in respect of earnings between the LEL and PT to protect contributory benefit entitlement.
16. Employers begin paying Employer's National Insurance Contributions above the Upper Secondary Threshold for U21s.They pay a zero rate up to this point.
17. Employers begin paying Employer's National Insurance Contributions with respect to certain apprentices who are under 25 above the Apprentice Secondary Threshold.They pay a zero rate up to this point.
18. Class 2 NICs are liable to be paid by all self-employed persons with profits above the Small Profits Threshold (SPT).The self-employed may choose to pay Class 2 if their profits are below the SPT.
19. Class 3 NICs can be paid by any contributor (employed or non-employed) to make the year a qualifying year for the basic State Pension (new State Pension from 6 April 2016) and Bereavement Benefit purposes.

Source: Extracts from HM Treasury Policy paper: Tax and tax credit rates and thresholds for 2017-18, published 23 November 2016, Annex A updated 22 November 2017 for 2018-19.