HINDSIGHT

Collegiate UNDERWRITING

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Welcome to the latest edition of our Hindsight publication.

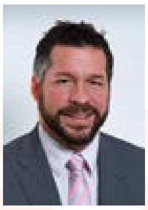
We have decided to concentrate this edition on looking at the various tax incentives on offer to support certain investments. It appears from our dealings with the FOS that they have concerns where tax incentives are offered there is a danger that these tax benefits obscure the investment decision that is being made and can lead to naturally cautious investors making some strange decisions. If they do not get the returns they were expecting they may wonder how they were persuaded to do what they did. A proportion will then complain.

There are certain types of complaints that we see again and again. They may only occur infrequently but when they do they are costly. Partial withdrawal from investment bonds are one such creature. We still fail to understand why life companies still make it so easy to take substantial funds out of bonds by partial withdrawal when they must know this is often to the disadvantage of the investor. We look at some of the continuing problems with investment bonds including the changes to the taxation rules of offshore policies.

On a similar theme we have finished with mortgage cases with an investment backed repayment vehicle.

My thanks go to Mark Gibbon, our Managing Director and Martin Archer, our Legal Director for producing this newsletter.

We hope that you will find these articles informative and useful.



If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk.

Richard Turnbull
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Investments with tax advantages

1. Pensions

We are seeing more claims where there has been a breach of the annual allowance, in particular where there are final salary pension scheme benefits to be taken account of. HMRC will take back the tax benefits that have been paid to the customer. Is there a loss? The loss calculation can be difficult but if the taxpayer has no tax relief then they will be paying tax when cash is extracted from the pension fund. If the customer is a basic rate tax payer this will be 15% (20% x 75%). However they will get the benefit of tax free roll up in the pension fund. It will be difficult to argue this is worth much. The calculation will be more complex if the customer is near the lifetime allowance threshold as they may have been denied the opportunity of claiming tax relief on a pension contribution in a future year.

There have been many changes to the tax rules on contributions to pension schemes and extraction of money from pension funds. However we have paid out much more in claims regarding unsuitable investments than on breaches of tax legislation. The IFA of course has a responsibility to get both bits right. Make sure the contributions are made in accordance with the rules and the tax legislation adhered to for the benefit of the consumer but also make sure the investment choice is in accordance with the attitude to risk, capacity for loss and sensibly diversified.

2 Enterprise Zone Trusts ('EZT')

Is it just footballers who bring claims against advisers for investing in EZT?

An investment in an 'EZT' is an investment in commercial property in a designated area. The key areas for looking at such an investment are potential capital growth and rental income. The tax relief issues should be secondary to the bricks and mortar.

This complaint was about an investment in an Enterprise Zone Scheme Investment syndicate. The complaint alleged that the customer was mis-advised in relation to risks and that all relevant information on tax including the possibility that HMRC might disallow tax relief was not provided. The driver for the investment was to obtain tax relief to clear a tax liability that would otherwise be payable. FOS considered the investment was unsuitable in that:-

- It exposed the customer to greater investment risk than he was prepared to take
- The tax efficiency of the scheme was uncertain and the risks were not properly explained. Providing a copy of the Information Memorandum did not replace the responsibility to give suitable advice

The FOS did not think it was reasonable to expect the customer to have to analyse lengthy complex documents to establish the workings and risks of the scheme. The investment was considered high risk and unsuitable for the customer despite the wish to mitigate the tax liability.

This complaint highlights FOS views on tax mitigation schemes. The investment must be suitable for the customer and backed up by the attitude to risk assessment. Any tax advantage that may be obtained must be clearly explained and any potential risks in obtaining that tax benefit clearly set out in the suitability letter.

3 Venture Capital Trusts

A venture capital trust or VCT is a UK closed-end collective investment scheme designed to provide private equity capital for small expanding companies. VCTs are companies listed on the London Stock Exchange, which invest in other companies which are not themselves listed.

Tax reliefs are different for investors in new shares issued by VCTs and investors who purchase second-hand shares, for example on the stock market.

Tax reliefs for second hand shares are:-

- exemption from income tax on dividends on ordinary shares
- exemption from capital gains tax on disposal of shares

Extra reliefs for new shares:-

- income tax relief at the rate of 30% on the amount subscribed on investments up to £200,000 in a tax year
- hold for at least 5 years

The price of VCT shares on the stock market (second-hand shares) tends to be lower than new shares, reflecting the absence of income tax relief.

4. Enterprise Investment Schemes (Seed Enterprise Investment Schemes)

An investment in small unlisted companies, must not hold more than 30%. Can be a single investment or through a collective investment scheme.

Seed EIS is the junior and riskier partner of EIS and gets more attractive tax breaks.

Tax reliefs for EIS are:-

- Income tax relief at 30% up to an investment of £1M
- No capital gains tax on disposal if held for more than 3 years
- Deferral of capital gains tax on disposal within certain dates
- Business property relief for IHT will apply after two years
- Carry back relief to previous tax year

Extra relief for SEIS are:-

- Income tax relief at 50% up to £100K
- Reinvestment relief on capital gain

For SEIS the company must have 25 or less employees and gross assets up to £200,000.

Warnings

- Illiquid as not traded and no secondary market
- Small part of broader wealth strategy
- High risk customer should only invest if they can afford to lose the whole of the capital

5. Business Property Relief

Inheritance Tax Act 1984 provides relief for a transfer of value made on or after 18 March 1986 if the whole or part of the value transferred relates to "relevant business property". This relief is given by means of a percentage reduction in any value transferred which is attributable to such property.

The detailed provisions are complex but broadly speaking in order to qualify for relief the property must:

- Be relevant business property
- Satisfy conditions as to a two year minimum period of ownership
- Assets must satisfy conditions as to a minimum period of use for the purposes of the business or, (apart from assets on loan to a partnership or company), be required at the time of the transfer for future use for those purposes

Relief for relevant business property is available subject to conditions for transfers of value made and chargeable during the transferor's lifetime, PETs chargeable on the transferor's death within 7 years, on death or in respect of periodic IHT charges relating to settled property.

Transfers of farming businesses are eligible for relief on the same terms as other businesses to the extent that agricultural relief, which is given in priority, is not appropriate.

Transfers of forestry businesses are eligible for business relief on the land and other non-timber assets. Relief is also available on the timber itself if tax is not deferred.

The categories of "relevant business property" include:

- Property consisting of a business or an interest in a business
- Any unquoted shares in a company
- Any land, building, machinery or plant which, immediately before the transfer, was used wholly or mainly for the purposes of a business carried on by the company of which the transferor then had control or by a partnership of which he then was a partner.

Subject to certain exceptions, relief is not available to businesses or shares in companies engaged wholly or mainly in dealing in securities, stocks or shares, land or buildings or in the making or holding of investments.

A business not carried on for gain is excluded from relief.

Generally to qualify for relief a transferor must have owned the relevant business property for two years immediately before the transfer or, if it replaced other relevant business property, the original and any replacement property must have been owned for periods totalling at least two years out of the five years immediately prior to the transfer. However for the unquoted shareholdings relief the 2 year qualifying period does not include any period of ownership of subsequently replaced shares unless they can be identified with the original shareholding

If the transferor acquired the business property on the death of a spouse or civil partner, it is treated as having been owned since the spouse or civil partner acquired it.

This relief is attractive to people looking to minimise any inheritance tax payable and has led to a growth in businesses set up to meet these criteria. We get enquiries from advisers looking at these for customers. Our view is that advice is the responsibility of advisers and our own views are based on suitability and risk. We are aware that product providers are promoting these investments to advisers and their customers as low risk. Our concerns are that FOS does not agree with this conclusion. The investments are in unquoted companies. Traditionally these are viewed as high risk investments and we believe that FOS will be of this opinion. Our concern is they are sold as low risk and if returns are not as expected the FOS will not agree with this assessment and find the advice was not suitable for anything other than an experienced high net worth investor.

6 Investment Bonds

6.1 Discounted gift trusts

These work for IHT planning and suit a customer who wants an income from capital but not access to the capital and work by setting up a trust which has a cluster of investment bonds as the assets of the trust. The settlor has the right to take income for life often at a rate of 5% and the beneficiaries have the right to the capital left on death of the settlor.

A recent complaint concerned the trust investing in illiquid assets. One of the funds was suspended. A decision was taken to stop the payments of the 5% to the settlor. There were a number of components to the complaint. None of these centred on the validity of the discounted gift trust which was accepted as being suitable for the customer's situation. The first part of the complaint was aimed at the suitability of the investments. These were not liquid and not able to fulfil the purpose which was to provide a level of withdrawal at 5% for life. The second was aimed at the cessation of withdrawals as these had an impact for inheritance tax purposes. The IHT 'nil rate band' had been used up in setting up the discounted gift trust. Any decision not to take the 5% withdrawal was effectively a gift of that money to the trust. To the extent that it was not covered by the annual allowance it was a chargeable transfer and subject to IHT at 20% with a further charge payable if the settler did not survive 7 years. A settlement was reached with the complainant.

6.2 Partial surrenders

We still see a small number of cases each year where a partial surrender has led to an unexpected and unnecessary tax charge. This is because the partial surrender is greater than the 5% cumulative allowance that can be taken from an investment without any tax liability. Usually there has been a very large withdrawal which should have been taken as a full surrender, either of clusters or the whole bond, but has been taken as a partial surrender. A chargeable event certificate will be issued by the insurer covering the insurance year. This runs from the date the policy is taken out and on the same date in subsequent years and ends on the day before the anniversary date. The gain arises in the tax year that the end date falls in. As an example a bond taken out on 1 November will have an insurance year of 1 November to 31 October each year. If a large partial withdrawal is taken out in February 2014 then it will fall into the insurance year 1 November 13 to 31 October 2014. A chargeable event certificate will be issued dated 31 October 2014 and will fall to be taxed in the tax year 2014/5. If the bond was subsequently surrendered on 31 March 2015 then the insurance year would become 1 November 2013 to 31 March 2015 and the chargeable gain would be recalculated looking at the withdrawals compared to the cost rather than by reference to the 5% rule. This would put the gain on the same calculation method as if the bond had been fully surrendered. The tax year is different as if it had been surrendered in February 2014, when the original partial withdrawal took place, it would have been taxed in 2013/4. This is unlikely to cause the same level of problems as the partial surrender. We have seen a number of cases where the partial withdrawal has been circa £300K and one extreme cases where it was over £1m.

If you become aware of such a situation then prompt notification to your insurer will ensure we can advise the best course of action to minimise the loss to the customer and a nasty blemish on your PI record.

6.3 Full surrenders

Since personal allowances were reduced for earnings greater than £100,000 in April 2010 we have seen a number of claims against advisers where there has been a full surrender. The adviser has calculated the amount of gain that will be subject to income tax using top slicing, which divides the gain by the number of years the bond has been held for, and ensured this falls within the basic rate tax band of the taxpayer. Advice has then been given that full surrender can take place with no tax liability. Unfortunately we have seen a number of instances where the gain has meant that income is greater than £100,000 and personal allowances have been restricted or removed completely with the result that the top sliced gain is exposed to higher rate taxes which are then applied to the whole of the gain.

By the time the taxpayer realises they have a problem there is usually no opportunity to widen the basic rate band to sort the problem out.

The important point is the whole of the gain counts as income in determining whether personal allowances are going to be restricted.

6.4 Offshore bonds

The taxation of offshore investment bonds used to be quite simple. They were used because they allowed gross roll up of any income/gains as no UK taxation was deducted in the bond. If the taxpayer was UK resident when the bond was surrendered they would pay basic rate tax on the full value of the gain. They would have a liability to higher rate tax if the top slicing calculation took part of the gain when treated as their marginal income, into higher rate tax. If the whole of the top sliced amount was in the higher rate bracket they would pay higher rate tax on all the gain, if only part it would be prorated. If the taxpayer was non-resident then any gain could be taken during the period of non-residency tax free.

This has all changed. From April 2013 a non-resident taxpayer can still be liable to tax in the year of return to the UK if they are away for five years or less.

We have already seen one large claim in respect of a gain realised when the taxpayer was non-resident but returned to the UK within the five year period.

Where the taxpayer is liable to UK tax the chargeable gain on an offshore policy is reduced if the taxpayer was not UK resident throughout the policy period. The reduction is pro-rata for the number of foreign days over the total days. Foreign days are days when the taxpayer is non-resident for UK tax purposes.

Changes in legislation often cause problems and we would be surprised if we do not see further claims in this area.

7. Mortgage advice and Investments

We have seen a number of claims where an interest only mortgage has been taken out by a customer. The repayment vehicle has been an investment in an Unregulated Collective Investment Scheme that was not advised on by the mortgage broker. The complainant alleges that the mortgage broker was aware of the repayment vehicle used to support the mortgage. The investment has fallen in value and the customer cannot afford to repay the mortgage.

To what extent is the mortgage intermediary responsible for the unsuitable investment? At this stage there is no regulated adviser that the customer can pursue for the sale of the unsuitable investment. They turn their attention to the regulated entity being the mortgage broker. They allege that if suitable advice had been given then a repayment mortgage should have been taken out. If that had been done it would have been clear that the customer could not afford the mortgage and they would not have proceeded.

We have had some success in arguing that even if the mortgage intermediary had recommended a repayment vehicle the customer would not have heeded this advice and on this basis there is no liability. However this depends on the individual facts of the case and will not always apply.

If this argument does not succeed then there is a chance that the loss will be the whole of the investment loss and not the capital repayments that would have been made by the time the complaint is resolved.

The Mortgage Market Review came into effect in April 2014. The clauses relevant to interest only mortgages were:-

For intermediaries

- The removal of the requirement on intermediaries to assess affordability.
- The removal of the non-advised sales process.
- Every seller required to hold a relevant mortgage qualification.

For lenders

- Lenders are fully responsible for assessing whether the customer can afford the loan, and they have to verify the customer's income. They can still choose to use intermediaries in this process, but lenders remain responsible.
- Lenders are still allowed to grant interest only loans, but only where there is a credible strategy for repaying the capital.

This should make interest only mortgages harder to come by. Borrowers should only be able to take out an interest free mortgage if they have a clear and detailed repayment strategy. However intermediaries should not assume they are off the hook for any liability should they recommend an interest only mortgage with an investment backed vehicle that does not repay the mortgage. Although lenders remain responsible they can involve intermediaries in the process. When a customer wants to complain the first point of contact is likely to be the intermediary not the lender.

If the customer is raising finance for an investment then the intermediary needs to be satisfied that the investment will repay the mortgage. Given the uncertainty over the value of any investment then the mortgage should only be advised where the customer has sufficient income to cover a repayment mortgage and this should be made clear to the customer at the time of the advice. If there is any doubt on the affordability of the mortgage then the intermediary should refuse to proceed.

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