UK Tax Bulletin

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Latest Rates of Inflation and Interest

The following are the current rates at August 2016

Current Rates	
Retail Price Index: July 2016	263.4
Inflation Rate: July 2016	1.9%
Indexation factor from March 1982: to June 2016 to July 2016	 2.312 Not yet published

Interest on overdue tax

Interest on all unpaid tax is charged at the same rate.

The formula is Bank base rate plus 2.5% which gives a present rate of 2.75% from 23rd August 2016

There is one exception: Quarterly instalments of corporation tax bear interest at only 1.25% from 16th August 2016

Repayment supplement

Interest on all overpaid tax is payable at the same rate.

The formula is Bank base rate minus 1% but with an overriding minimum of 0.5% which applies at the present time.

Official rate of interest

To 6 April 2014: 4%

To 6 April 2015: 3.25%

From 6 April 2015: 3%

Non Doms after April 2017

It was a surprise to discover that while we were all dangling our feet in various swimming pools in the middle of the summer, HMRC were publishing the long-awaited further guidance regarding the reform to the taxation of non-doms. 18th August? What sort of time is that? Anyway, I am sure we are all extremely grateful.

We were missing some very important details about the proposals which are expected to come into force on 6th April 2017 regarding long-term residents, returning non-doms, the treatment of UK residential property and the capital gains tax rebasing at April 2017.

There was some hope (or prayer) that these changes might be deferred – and perhaps that there may be some reliefs for de-enveloping. Unfortunately not. HMRC has firmly said No to both suggestions. So now it is reasonably clear what is in prospect next April.

Non Doms: UK Residential Property

Where a UK asset is owned by an offshore company, the shares in the company are foreign assets and are excluded property for IHT purposes in the hands of a foreign domiciled individual. HMRC announced last year that they want to remove this excluded property treatment in respect of UK residential property – but they did not say how this would be done.

They have now. The shares in the offshore company will no longer be excluded property to the extent that the value of its shares is attributable directly or indirectly to residential property in the UK. At first sight, this seems straightforward enough; there is no tracing mechanism and it deals satisfactorily with the cases where the offshore company has other assets which are not UK residential property. However these things are never simple.

It is the shares in the offshore company which will not be excluded property and it will be the value of those shares (to the extent that that value is attributable to UK property) which will be chargeable. It is therefore necessary to value the shares and not the underlying property – although the value of the property will be an important component. I see lots of really interesting arguments here.

An advantage may therefore arise if the shares in the offshore company are held by a number of different members of the family so that a substantial minority discount might be available. I see even more interesting arguments here.

There is also the possibility that the older generation may have shares carrying only limited entitlement to the company's assets (but perhaps most of the votes) and the younger generation may have a different class of shares where the value is all attributable to the UK residential property.

It will be necessary to have regard to the new and specifically targeted anti avoidance rule but I am sure there will be opportunities which are consistent with the intention of Parliament.

Where the shares in the company are in a trust some serious problems arise because of the ten-year charge and the gifts with reservation rules. If a foreign settlor establishes a trust with excluded property (for example shares in the offshore company), the excluded property rules trump the gifts with reservation rules so there is no charge to inheritance tax on the death of the settlor – even if he is deemed domiciled UK at the time. However, if the offshore company's shares cease to be excluded property, his reservation of benefit comes into play and on his death, the value of the previously excluded property will be chargeable as part of his estate. That may come as unwelcome surprise – and what is worse, the fact that the value may be in the settlor's estate would not protect the trustees from the 10-year charge – because (unless it was a life interest trust established prior to 22nd March 2006) they will be subject to the 10-year charge, and to an exit charge on any distributions, because the shares will no longer be excluded property. Foreign trustees are going to love that.

There is clearly an enforcement issue here because the offshore trust and the offshore company will invariably be outside the jurisdiction. HMRC propose making the settlor, the executors, the trustees, the directors – and pretty much everybody they can find - liable for the tax and to extend the scope of the Inland Revenue Charge in section 237 IHTA 1984 so that the property cannot be sold without the tax being paid.

The definition of UK residential property deserves some attention as it includes any property which has been a dwelling at any time within the two years preceding the relevant transfer – and will include residential property purchased off plan. Otherwise, the definition of residential property will follow the definition in the non-resident capital gains tax rules.

A question (more of a spectre) appears in connection with debts. The normal deduction for debts against the property will continue. Accordingly, a purchase of a UK residential property for £10m with a mortgage of £10m will have a UK net value of zero for IHT purposes – which will keep the property out of the IHT net, at least for a while. However, it will be remembered that certain debts charged on UK residential property are disallowed for the purposes of inheritance tax, particular where the property is refinanced.

Continuing this theme, it is now proposed that:

> "any loans made between connected parties will be disregarded when determining the value of the property which will be chargeable to IHT."

There are no further details. We do not know which of the numerous definitions of "connected parties" will apply here, nor do we know whether this change will be retrospective. Will a loan from a connected person to purchase a property before April 2017 be caught by the new rules, or will it only apply to loans after that date? (No – I don't think so either).

You have to feel sorry for the trustees of a trust which owns a UK residential property which it bought for £5m from funds borrowed from somebody connected with the settlor. They have an asset which is worth zero but they will be charged inheritance tax on the basis that they have assets worth £5m. HMRC may deem them to have this value – but that does not mean that they have money to pay the tax.

(Actually one wonders why HMRC need all these complications. Why don't they just deem everybody to have made a capital gain of £50,000 and charge them CGT accordingly? Of course that would be silly….)

And what if the lender was domiciled in the UK. The loan would be an asset in their estate but it would not be deductible as far as the trustees are concerned. So the trustees would be liable to inheritance tax on an asset worth £5m and the lender would also liable to inheritance tax on an asset worth £5m. The amount chargeable to inheritance tax is doubled. What a great trick. Do this a few times and The Deficit will disappear completely.

Maybe Mr. Hammond has seen a conjuror finding a £1 coin behind his ear and thinks it really is magic.

There is also a targeted anti-avoidance provision. HMRC suggests that this is necessary because:

> *"There have been instances in the past in which individuals have taken steps to avoid a charge to IHT."*

Well, blow me down. Only since the Roman Empire.

Long term residents

Deemed UK Domicile

The proposal here is that individuals who have been resident in the UK for at least 15 out of the last 20 years will be regarded as deemed domiciled for all relevant tax purposes and the 17 out of 20 year rule for inheritance tax will be replaced by this new rule. All this is well known.

A person deemed domiciled under this rule will pay tax on their worldwide income and gains – and will no longer be able to claim the remittance basis.

One of the problems with this new rule would be that it would take somebody six years of non residence to escape from deemed domiciled status. It is now proposed that the deemed domiciled status will fall away after 4 consecutive years of non residence. (This nicely corresponds with the spouse election).

Residence for this purpose means tax residence and this will be determined by reference to the residence rules in force for each of the relevant years. It will not be possible to use the Statutory Residence Test entirely for this purpose. (It is a good job I did not throw all my copies of IR20 away – it is clearly back in business). Split years will count and so will all years of residence during childhood.

There are going to be transitional rules to ensure that there is no retrospective effect on those who were non resident before these new proposals were announced. There is also some seriously good news regarding mixed funds and an opportunity to unmix them which will be an enormous comfort to many people – see further below.

Inheritance Tax

It is confirmed that trusts established prior to becoming deemed domiciled under this test will continue to be capable of being excluded property for IHT purposes.

2017 Rebasing

Further details have now been provided about the surprise announcement in the Budget that non-doms who become deemed domiciled under the 15 out of 20 year rule on 6th April 2017 will be able to rebase their overseas assets for capital gains tax purposes.

It now seems clear that this will be enacted exactly as it says on the tin – well almost. It will only apply to individuals who become deemed domiciled under the 15 out of 20 years rule on 6th April 2017. It will not apply to those who become deemed domiciled in years after 2017, or to returning non-doms – and it will only apply to non-UK assets.

There are however two new conditions. The rebasing will be limited to those assets which were situated outside the UK on 8th July 2015. That will be a problem for somebody who is the settlor (or a beneficiary) of a trust with foreign assets as they might not benefit from this rebasing at all. The individual would not own the foreign assets – they would be owned by the trustees – and although the settlor would be taxed on the gains, he would not qualify for rebasing.

The second condition is that the individual must have paid the non dom charge at some point – but it would seem that only once is enough.

It is possible (perhaps) that assets could be extracted from a trust under a holdover relief election so that they are in the individual's possession on 6th April 2017. The assets would have been foreign assets on 8th July 1015 although they would not then have been in the possession of the individual – but perhaps that will not matter. Unfortunately, we do not yet have the draft legislation in respect of this rebasing but it should be coming along shortly.

It should, however, be carefully noted that if the foreign asset was purchased wholly or partly with foreign income or gains, the disposal of the asset may not give rise to a capital gain because of the rebasing election, but the remittance of the proceeds would represent the remittance of the earlier income or gains which were used to purchase the asset.

Mixed Funds

There is some seriously good news here. Everybody knows about the problem with mixed fund – that is a fund which contains a mixture of capital, income and gains. If you remit money from a mixed fund it is regarded as income first, then gains and only when every taxable element has been treated as remitted and taxed, can you remit the original capital.

HMRC are proposing a one year window from April 2017 enabling the individual to rearrange the mixed fund and separate it into its constituent parts of capital, income and gains – so that subsequent remittances can be made from whichever account he chooses.

This will only apply to bank deposits and similar accounts – but other assets can be sold and the proceeds separated during the window period.

This will be incredibly welcome – but you must be able to determine the constituent elements of the mixed fund. This is bit tough because the mixed fund may have existed for years, long before there was ever any reason to keep this information – but HMRC are unsympathetic. They say (politely) that we should not look a gift horse in the mouth – which is perhaps fair enough.

This rule will apply to all non doms and those deemed to be UK domiciled – but not for returning non doms.

Trusts Ring Fencing

HMRC have now explained how they are going to deal with non resident trusts which are existence at April 2017 established by a person who becomes deemed domiciled under the 15 out of 20 year rule. (Returning non doms? – sorry, no chance.)

The suggestion has always been that the income and gains would be protected – unless and until they are distributed. But how the distributions will be taxed was a mystery.

The answer is that section 86 TCGA 1992 will apply to the gains made by the trust and they will be automatically treated as the gains of the settlor (he will be resident and deemed domiciled after all) – but only if there is a distribution or benefit out of the trust to the settlor or his family.

The settlor will not be taxed under section 87 on benefits from the trust. If there are any distributions, section 86 will apply; and if there are none, there will be no charge to tax.

As far as income tax is concerned the settlements legislation in section 624 ITTOIA 2005 and the transfer of assets abroad rules in section 720 Income Tax Act 2007 which treat all the income of the trust as the income of the settlor, will be disapplied to a certain extent. There will be no charge on the settlor if there are no distributions or benefits. However, if there are any such distributions or benefits, the entire protection will not be lost but the amount of the distribution or benefit will be taxed on the settlor to the extent that it can be matched with the income of the trust for that year.

These protections only apply to foreign source income because UK source income is taxable anyway.

It is perfectly OK for a potential deemed dom person to create a trust (or add assets to an existing trust) before next April to take advantage of these protections and this is clearly to be recommended – but do not transfer anything afterwards. If any assets are added to a trust after 5th April all protections are lost.

Under the circumstances, it may be a good idea to put everything you can into a trust before next April – and equally important to have all the distributions you might need as well, because after April 5th you will be a bit stuck.

One area of concern will be the meaning of a distribution in this context because an inadvertent distribution will have really serious consequences. A distribution includes any kind of direct or indirect benefit from the protected income. There is no de minimis provision so any kind of nominal or theoretical benefit could be catastrophic. (Just look at *Flix Innovations Ltd v HMRC* to see how bad this can be),

Returning Non Doms

There is nothing in the latest document to provide any relaxation to the proposals for returning non doms – those people who were born in the UK with a UK domicile of origin but who subsequently obtain a foreign domicile of choice but find themselves UK resident. They will be treated as deemed domiciled for all tax purposes with no concession at all to the fact that they actually have a foreign domicile.

With one exception. They will not be regarded as domiciled for IHT purposes for the first year of UK residence to protect them from an unexpected an accidental charge if anything were to happen to them while they are in the UK. So, somebody who comes to the UK to care for elderly or sick parent and is in the UK for long enough to become resident does not risk being exposed to millions of pounds in tax by these new rules. At least for that year.

EIS Relief

Clause 35 of the Finance Bill has been introduced to strengthen the notoriously tough Transactions in Securities legislation so that when funds are extracted from a company in capital form (for example, on a liquidation) instead of by way of dividend, HMRC may counteract the perceived tax advantage and charge the receipt to income tax.

HMRC have provided some guidance to the CIOT relating to clearance applications (which is pretty helpful because there is no clearance procedure) and to help us understand the new legislation.

Essentially the idea is that if within two years following the liquidation of a company, an individual carries on the same or similar trade or activity that was carried on by the company, the liquidation proceeds can be taxed as income if it is reasonable to assume that a main purpose of the arrangements was to obtain a tax advantage.

This would include carrying on the trade or activity as a sole trader, through a partnership, through another company – including for example, working as an employee for a spouse in a similar trade.

I can see a lot of arguments arising regarding the main purpose test – because it is very likely that in most cases, the other conditions of clause 35 would be satisfied. This would not of course apply if somebody sells up and retires – but people are building businesses all the time and some of them have to be wound up for any number of commercial reasons. However, persuading HMRC that the arrangements are not tax motivated is likely to be a bit of a mission – particularly if the taxpayer could have reached the same result in a different way which would have given rise to lots of tax.

What has this got to do with EIS? If I invest in an EIS company, I would obviously do so with the tax reliefs in mind. When in due course the EIS company's trade comes to an end (because perhaps it was a specific project and when that project is over the company is wound up and the funds distributed to the investors) the gain made on the disposal would be free of capital gains tax. That is what the EIS is all about and the rules were drafted expressly for that purpose.

However, woe betide the EIS investor who then becomes involved a similar trade or activity – perhaps by making another EIS investment, which the government encourages him to do. He will need to be extremely careful to avoid getting caught up in all this and end up paying income tax on the whole of the capital gain, rather than it being tax free.

There is no clearance opportunity so is the investor going make another EIS investment with the risk of these tax consequences? Hardly. What sensible serial EIS investors would put his capital gains tax exemption at risk in this way.

EBTs – New Proposals

Another long-awaited document was published on 10th August setting out the latest HMRC proposals for EBTs. In particular, these proposals address the thorny problem of those EBTs which were established prior to the 2011 disguised remuneration rules in Part 7A and where loans had been made to employees.

Those loans were not chargeable at the time, nor were they caught by Part 7A – but a charge to tax would arise if the loans were to be released. They have therefore been frozen – in many cases indefinitely, pending a good idea.

However, following a clue in the Budget, it is now firmly proposed by HMRC that where such loans remain outstanding at 5th April 2019 they will be brought into charge to income tax.

This is only a technical consultation document – but there are only a few weeks given for comments to be made so it is very unlikely that there will be any significant change to the overall proposals.

Bribery

I read a charming piece in a tax publication recently explaining that the World Bank has a league table of countries where it is necessary to bribe tax officials. It is perhaps a comfort to know that there is less pressure on taxpayers to bribe tax officials in OECD countries than elsewhere.

Actually I do not find it very comforting at all. You would have thought that this is such a serious matter involving the breaking of many laws, that it would have a rather higher priority than the mere compilation of a table – compared for example, with the vigorous pursuit of those who (carefully) stay within the law.

However, it is very comforting to consider how lucky we are (and how proud we should be) to live in a country where the very idea of bribing a tax official is completely unthinkable.

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