UK Tax Bulletin

December 2016

FIELD COURT TAX CHAMBERS

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Latest Rates of Inflation and Interest

The following are the current rates at November 2016

Current Rates	
Retail Price Index: November 2016	265.5
Inflation Rate: November 2016	2.2%
Indexation factor from March 1982: to October 2016 to November 2016	 2.333 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 – Further Details

The Draft Finance Bill published on 5th December provided a good deal of new information and clarification – although not all of it welcome – about the proposed changes in the taxation of non doms from 6th April 2017.

Rebasing

The anticipated provisions regarding rebasing at 2017 are all there. The rebasing will only apply to foreign assets owned on 5th April 2017 and disposed of after that date, by a person who becomes UK deemed domiciled on 6th April 2017 (this does not include anybody who becomes deemed domiciled at any other time) and they must have paid the non dom charge at least once.

The opportunity to elect for rebasing only applies to individuals, not trustees; nor does it apply to returning non doms – those who were born in the UK and had acquired a foreign domicile of choice but have since become UK resident.

The asset must have been situated outside the UK on 16th March 2016 (or since the date of acquisition by the individual, if later).

This looks straightforward – but I fear it will be much more complex before it reaches the statute book.

Mixed Funds

The proposal for a one year window for non doms to un-mix their mixed funds has been extended to a two year period from 6th April 2017 which is obviously very welcome.

However, it is now quite clear that this will apply only to bank accounts where the elements of mixing in the fund can be precisely identified. There seems to be no reason why other assets (such as shares or a foreign property) cannot be sold and the proceeds deposited in an account which would obviously then be a mixed fund – and for the account to be "cleansed" under these rules before the deadline.

This opportunity to claim this treatment only applies to those non doms who become deemed domiciled under the 15 out of 20 year rule – not to returning non doms – and it does not apply to trustees.

Trust Protections

It has been suggested on earlier occasions by HMRC that there should be some protection for trusts established by non doms who become deemed domiciled on 6th April 2017. (This does not apply to returning non doms, of course; nothing applies to them).

The general idea is that such a trust will remain free of UK tax without any of the anti-avoidance transparency provisions, providing there are no distributions from the trust and no additions to it either.

These protections apply only to trusts, they do not apply to assets held by a company owned directly by the non dom individual.

As far as capital gains tax is concerned, section 86 will not apply in these circumstances to treat the settlor as automatically taxable on the trustees' gains (unless the trust becomes tainted by post April 2017 additions); section 87 will apply to charge tax on distributions or benefits to beneficiaries. If such benefits are provided to close family members, they will be taxed on the settlor; benefits to others will be taxed on the recipient in the normal way under section 87. It is interesting to note that a close family member does not include an adult child.

A new provision has been inserted so that where a distribution is made to a non-resident beneficiary, this will not diminish the pool of trust gains. Such distributions will be completely disregarded, leaving the stockpiled gains untouched and able to be attributed to UK resident beneficiaries who receive benefits from the trust.

As far as income tax is concerned, UK source income will be fully taxable with no protections at all. Foreign income will be taxed on the settlor only if the income is paid out to a close family member. Otherwise, the anti avoidance provisions will all be turned off.

Distributions of income to beneficiaries who are not close family members will be taxed on the recipient in the normal way.

The rules will similarly apply to income arising in an underlying company owned by the trust – there will be no need to pay up the income to the trust to enable these protections to be obtained.

Accordingly, it will obviously be to the advantage of every long term resident who will be deemed domiciled on 6th April 2017 to ensure that everything possible is in trust before that date so these protections can be obtained. That will also protect the assets from inheritance tax because the excluded property status of the settled property will continue to apply.

It is interesting to note that capital payments to a UK resident beneficiary who becomes non-resident before the trustees make a gain will not be charged on the gain. However, capital payments to a non-resident who later becomes UK resident will be chargeable when the trust makes a gain. That is really tough – and although these rules are sort of parallel, it will come as an unpleasant surprise to somebody who becomes resident here for the first time, that he can be taxed on money that he received years ago, when he was non resident.

Estate Double Taxation Agreements

The Draft Finance Bill contains provisions which will interfere substantially with the estate double taxation agreements with countries such as India, Pakistan, France and Italy where the deemed domicile rule is excluded.

A person who is domiciled in the UK under the deemed domicile rule but is also domiciled in one of these other countries, is not exposed to UK inheritance tax on death in respect of his assets outside the UK – providing they do not pass under a disposition regulated by UK law.

It is proposed that these double taxation agreements will be overridden by the new legislation in circumstances where the other country does not charge inheritance tax (or a tax of a similar character to inheritance tax) - or if the corresponding tax in that country on the particular transfer has “an effective rate of 0%”. In that case the full UK liability will become payable.

It remains to be seen whether this will apply in circumstances where the other country has corresponding tax with a positive rate, but for some reason – such as debts or the availability of an exemption - no tax is actually payable in that country. The tax may be zero because the rate of tax is 0% or it may be zero because the chargeable amount is zero even though the rate of tax applicable may be (say) 20%. The reference to the effective rate charged on the transfer, does not look promising. However, the courts have had fun with this conundrum before.

Non Doms: UK Residential Property

I think everybody now knows that on 6th April 2017 where a foreign domiciled person has an offshore company which owns a UK residential property, their shareholding in the offshore company will cease to be excluded property to the extent that the value of the shares is attributable to the UK residential property.

Where the company is owned by a trust, it will often be the case that the settlor will have a reservation of benefit - and therefore, in the event of his death, the value of the shares will form part of his estate because they would no longer be excluded property. Furthermore, the trustees will be exposed to the ten year charge on each tenth anniversary.

The Draft Finance Bill provided a good deal more information about these proposed rules – some of which may come as a bit of a surprise.

The value to be brought into charge is the net value of the asset after deducting any loans on the property – and it may be remembered that relief for these loans was curtailed in 2013 to exclude from relief any loans taken out by way of refinancing.

To reduce the UK tax exposure, one might take out a loan charged on the property and deposit the funds abroad. The funds deposited abroad would be excluded property and only the net value of the UK property would be chargeable.

That was a good idea but in 2013 this refinancing arrangement was outlawed and in such circumstances, the loan will simply not be deductible from the UK asset in determining the amount chargeable to inheritance tax.

There was some suggestion earlier in the year that relief for loans would be further restricted, if they were made by connected persons. That gave rise to some serious potential difficulties because a loan is still a loan, even if it comes from a connected person – you still have to pay it back.

However, HMRC have abandoned the connected loans idea – but they have a new and better plan. They are not going to restrict debts as a deduction from the UK property even if they are from connected persons – but they will regard the loan itself as within the scope of inheritance tax to the extent that its value is directly or indirectly attributable to UK residential property. There is no grandfathering of earlier loans – so there will be a lot of people caught by the retrospective application of these provisions.

So, if the lender is a close company or a trust or an individual, the loan will be regarded as a UK asset and subject to inheritance tax on the death of the individual, or the settlor perhaps, and of course subject to the ten year charge in the case of trusts.

Furthermore, secured collateral and secured guarantees will also be regarded as UK assets (and therefore within the scope of inheritance tax) where the substantive loan is used to acquire UK residential property.

Two Year Rule

Just to make matters more difficult, the Finance Bill provides that property which is caught by the above provisions relating to UK residential property will not be excluded property for two years following its disposal – that is the sale of the property or the repayment of the loan. This is obviously to prevent the avoidance of the charge by the repayment or sale of the property immediately prior to (say) a ten year anniversary.

This provision is of seriously wide application. I have often suggested that when HMRC start wanting to tax the foreign assets of foreign individuals living abroad, they will truly have gone completely mad. I think we are getting close.

Imagine the position of a foreign domiciled and resident person who may never have been to the UK; he may not even speak the language and he has no UK assets and never had any. He has lived all his life in Ruritania. Nevertheless, he will be chargeable to inheritance tax on his death just because he lent money to a friend in Ruritania who used it to buy an investment property in the UK which he sold two years ago.

It is no justification to say that HMRC would probably never know, and would not pursue the foreign person in these circumstances. Why not? If there are tax obligations, they should be adhered to and all tax liabilities properly collected and paid.

TAAR: Inheritance Tax

The targeted anti-avoidance rule which had been proposed in earlier drafts continues and is intended to supplement the GAAR. The definition of when the TAAR will apply has been extended and will now include arrangements (whenever made) the purpose "of which is to secure a tax advantage by avoiding or minimising the effect of [the new rules]".

Read literally this could include giving away property now while it is excluded property in the knowledge that it will cease to be excluded property on 6th April 2017. The same would apply to a third party sale. That would seem to be an extreme view – let us hope too extreme. After all, it would not be avoiding the effect of the new rules because the new rules would still be of full effect and would continue to apply with full force to the taxpayer. It is just that the rules do not come into force until 6th April 2017. There would be no point in saying that the rules don't come into force until 6th April 2017 if they are going to apply anyway to transfers before that date.

It is to be hoped that some clarification is forthcoming soon.

Tax Avoidance – Sanctions and Deterrents

It may be remembered that in August HMRC published a consultation document entitled "Strengthening Tax Avoidance: Sanctions and Deterrents" which contained a number of proposals for deterring tax avoidance. The main thrust of the proposals was that there should be penalties for enablers of tax avoidance which is defeated.

HMRC explained that these proposals are targeted at people who are undertake transactions where tax is saved in a way which Parliament did not intend. Penalties are to be charged on anybody who enables others to avoid tax – such as promoters, trustees and even lawyers who advise on the arrangements.

Without wanting to get too philosophical, I am struggling with the logic here. If somebody enters into a transaction with the intention of saving tax and following a challenge by HMRC, the court find it succeeds, the transaction would have been in accordance with the intention of Parliament. If however the transaction is not in accordance with the intention of Parliament, it will fail and will not save any tax.

So if it succeeds, it is OK; if it fails, there is no tax saving anyway – so that is OK too. So where is the problem?

The problem is that HMRC suggests that if the claim fails, the taxpayer should be penalised – and so should all the advisors. What? Just for expressing a view on the law which does not correspond with that of HMRC and seeking to have the matter adjudicated by the courts.

That is not a very engaging stance. It may be a popular governmental approach in North Korea but I think most people would prefer to live in a country where obeying the law is good and breaking the law is bad. For a government to say that you have not broken any laws but we are going to penalise you anyway – because you have disagreed with us – is surely unacceptable in any civilised society.

I cannot resist the following extract from Dicey's Law of the Constitution (10th Edition: 1959) – although I think the principle goes back to Magna Carta:

> "no man is punishable or can lawfully be made to suffer in body or goods except where distinct breach of the law established in the ordinary legal manner before the ordinary courts of the land".

Of course we know what HMRC is getting at. It is a genuine problem which deserves to be addressed but it is important not to get carried away. HMRC might usefully reflect on whether it should be subject to the same penalty if it was unsuccessful in challenging a claim by a taxpayer to tax relief – and if not, why not? HMRC has been quick to say that these penalties will not affect those who engage in legitimate tax planning – but that is too disingenuous for words. We have all seen examples of people being criticised as repugnant tax avoiders merely by using a tax relief in exactly the way it was intended to be used.

There is also the problem arising from the decision in *Harben Barker v Mehjoo [2014] ECWA Civ 358*. The client seeks tax advice about a potential tax liability. The advisor could tell him how to save the tax – in which case he is penalised by HMRC. Or the advisor could refrain from telling the client how to save the tax – in which case the client sues him for negligence. This is by no means a fanciful concern.

The Draft Finance Bill contains a refinement to the proposals which specifically targets designers, managers, marketers and enablers of tax avoidance arrangements. The category which will affect advisors is that of "designer" - a person who is to any extent "responsible" for the design of the arrangements. A professional person giving his advice on the law can hardly be regarded as somebody "responsible" for the design of the arrangements. However, it is clear that the legislation is designed to bring them within its scope.

In particular, it is suggested that "advice used in the design of the arrangement or of a proposal" will be caught if it is relevant advice – that is to say the advice suggests arrangements or alteration in proposed arrangements and it is reasonable to assume that the suggestion was made with a view to arrangements being designed in such a way that a tax advantage might be expected to arise. It does not include advice which can reasonably be read as recommending against the proposal.

It is possible to take different views of the meaning of these words but it is clear that HMRC have advisors in their sights. On one reading, anything would be able to be caught – and that is repugnant to anybody who considers that a citizen is entitled to take legal advice or to challenge the view of the state.

The penalties which were originally envisaged were eye watering – like the advisor was going to be liable for a penalty equal to the whole of the tax saving – but HMRC have revised their proposal so that the penalty to be imposed on the enablers or the designers will be equal to the fee which they received for their participation or contribution to the arrangements. It is interesting to contemplate whether such a fee would be tax deductible. If not, and one can see good reason why such a penalty would not be tax deductible, this would represent a significant further penalty.

A problem arises with legal privilege because an advisor may be unable to defend himself against a penalty without breaching privilege. Accordingly, the legislation is to provide some special provisions to allow a relevant lawyer to make a declaration (which the Tribunal is obliged to accept) that the advice in question is privileged and if it were not privileged, it would be relied on by him for the purpose of establishing that he was not liable to a penalty.

I think there may be some way to go with all this.

It may be instructive to contemplate how this approach would apply in other branches of the law. Can you imagine somebody being prosecuted where the prosecution case would be:

a) The accused did not intend to break any laws.
b) The accused did not break any laws.
c) The accused spent considerable sums on good legal advice to make sure he did not break any laws.
d) Even if the advice was wrong or the outcome of his arrangements did not turn out as intended, he still did not break any laws.

And the verdict:

- A substantial financial penalty is imposed on the accused who did not break any laws; and
- A substantial financial penalty is imposed on the lawyer who advised him correctly that he was not breaking any laws.

I don't think you have to be a purist to feel that there is something seriously wrong here.

Foreign Currency Assets

The recent case of Knight v HMRC TC5544 provides another confirmation of the much misunderstood capital gains tax positon when a foreign asset is sold.

If I buy a house in the USA for $500,000 at a time when the exchange rate is £1: $1.50 and sell it for $700,000 at a time when the exchange rate is £1: $1.30, my capital gain is not $200,000 converted at 1.30 = £153,846.

Unfortunately, that is much too simple and try as he might, Mr Knight was unable to persuade the FTT that this was the right result. It wasn't and there was just too much authority against him – but you can understand why he said this was a sensible result.

It is necessary to recognize that foreign currency is a chargeable asset for capital gains tax purposes. That means you have four stages to consider.

- The acquisition of US dollars
- The disposal of those dollars and the acquisition of another asset – the house
- The disposal of the house and the acquisition of US dollars
- The disposal of the dollars and the conversion to sterling.

The acquisition and disposal of the dollars at the outset is unlikely to give rise to any gain or loss because that will occur within a very short time scale. The same may apply at the other end when the property is sold. However, if there is a delay in the use of the dollars at the beginning or the conversion back to sterling at the end, a gain can arise on those occasions.

As far as the house is concerned it was bought for $500,000 when the sterling equivalent was £333,333. When the house was sold for $700,000 the sterling equivalent was £538,641. So the gain on the house for UK capital gains tax purpose is £205,128 and not £153,846.

It works the other way too of course to create a (possibly unexpected) reduction in the gain if the exchange rate goes in the opposite direction.

Happy Christmas

Peter Vaines
Field Court Tax Chambers
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Field Court Tax Chambers

Contact
Peter Vaines
Field Court Tax Chambers
3 Field Court
Gray's Inn
London WC1R 5EP

Tel: 020 3693 3700
pv@fieldtax.com
www.fieldtax.com