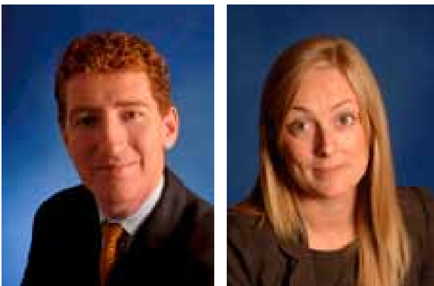
The Winds of Change: Recent UK Private-Client Developments



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Introduction

The UK has seen some dramatic changes in private-client taxation in the last two years. This article focuses on the Finance Act 2013 changes and the Budget 2014 announcements as currently expressed in Finance Bill 2014.

The principal changes affecting high-net-worth private clients are:

- income tax and capital gains tax (CGT) changes:
  - statutory residence test – and the consequential limited extension of the CGT temporary non-residence rules to income tax,
  - abolition of “ordinary residence”,
  - restrictions on dual-contract planning,
  - remittance-basis changes,
  - changes to the attribution of gains of offshore companies to shareholders and
  - clampdown on offshore intermediaries;
- changes to the taxation of UK residential property:
  - penalisation of corporate holding structures for high-value residential property – and its future extension to lower-value properties – and

- extension of CGT on residential property to non-UK residents;
- changes relevant to estate planning:
  - new non-UK-domiciled spouse inheritance tax election and
  - restrictions on using debt to mitigate inheritance tax;
- continued crackdown on tax avoidance:
  - introduction of the general anti-abuse rule (GAAR) and
  - further changes in Finance Bill 2014.

Since the first-named author came to the UK from Ireland in 2003, the Labour Government and now the Conservative/Liberal Democrat coalition Government have been constantly amending the tax legislation affecting private clients. The last two Finance Bills have been no exception, with Finance Act 2013, in particular, necessitating a review of every residential-property holding structure with a corporate owner, followed by a restructuring in many cases.

Income Tax and CGT Changes

Changes to UK residence rules

Introduction of statutory residence test

As tax advisers to internationally mobile private clients, we welcomed with great excitement the introduction of a statutory residence test (SRT) in the UK. For the first time, we can now, in most cases, advise clients with certainty on how many days they can spend in the UK without becoming UK resident for tax purposes. This may be a "given" for Irish tax advisers, but in the UK we were never able to do this with certainty before 6 April 2013, the UK's "residence rules" having been based on case law and HMRC practice (as expressed first in its publication IR20[1] and subsequently in HMRC6, with the latter document, in particular, being inconsistent and confusing).

A full discussion of the detail of the SRT is beyond the scope of this article. However, it is broadly based around three key tests: the "automatic overseas" test, the "automatic residence" test and the "sufficient ties" test. Where clients do not fall within the limited bounds of the automatic tests, their residence status will be determined by the "sufficient ties" test. This test determines how many days an individual can spend in the UK without becoming resident, based on the extent of his or her other specified "ties" to the UK. The exhaustive list of relevant ties comprises:

- family tie – having a UK-resident spouse, civil partner or minor child,
- accommodation tie – having a place to live in the UK (which need not be owned),
- work tie – working in the UK for at least 40 days in the year,
- 90-day tie – having been present in the UK for more than 90 days in either or both of the two preceding tax years, and
- country tie (relevant only to "leavers"[2]) – where the country in which the individual is present for the greatest number of days during the tax year is the UK.

Each of the above ties is the subject of detailed provisions set out in the legislation,[3] which will of course need to be considered closely in every case.

A quid pro quo for the taxpayer's gaining of certainty regarding his or her residence position has been the extension of the CGT temporary non-residence anti-avoidance provisions to income tax for a number of income categories where the taxpayer is in a position to control the timing (such as dividends from closely held companies[4] and redemptions of offshore life policies[5]).

Abolition of "ordinary residence"

The concept of "ordinary residence" was abolished by Finance Act 2013 with effect from 6 April 2013. This has been done as part of a move by HMRC to simplify the UK tax system. Unlike in Ireland, the definition of "ordinary residence" was never codified in the UK, and the only thing that is clear from a review of the relevant case law is that not even the courts could agree on what it meant! In practice, the change is unlikely to have any significant impact, as transitional reliefs have been introduced in key areas.

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1 Taxpayers in *R (Davies and another) v HMRC*; *R (Gaines-Cooper) v HMRC* [2011] UKSC 47 pursued HMRC to the Supreme Court unsuccessfully, claiming that IR20 should be applied in their cases.
2 "Leavers" are defined as those who have been UK resident in one or more of the preceding three tax years.
3 Schedule 45 Finance Act 2013.
4 Section 401C Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005) inserted by Finance Act 2013 s218, Sch. 45 paras 131, 133.
5 Sections 528 and 528A ITTOIA 2005 as substituted for the previous s528 by Finance Act 2013 s24, Sch. 8 paras 1, 3.

Restrictions on dual contracts

Under the previous rules, individuals who were resident but not domiciled in the UK could potentially enter into dual-contract arrangements designed to segregate their onshore and offshore earnings. Although this advice may have been effective some years ago, it had gradually become increasingly problematic as HMRC challenged dual-contract arrangements, on the basis either that they were in fact a sham or that the apportionment between the onshore and offshore duties was incorrect. The use of dual contracts has been further restricted by Finance Bill 2014 by the denial of the remittance basis where the two employments are related and the two employers are associated. Even before this change, however, most sensible advisers had avoided dual-contract arrangements for some years.

By contrast, overseas workday relief (OWR), which involves only one employer, was a much more acceptable form of planning for newly arrived UK residents who were non-ordinarily resident, as it was specifically permitted by IR20 and then HMRC6. The same measure that has abolished ordinary residence has, nonetheless, retained OWR and put it on a statutory footing.

OWR is a very valuable relief and is available to individuals who come to the UK regardless of their intention to settle there, provided that they are non-UK domiciled and have not been resident in the UK in any of the three tax years before coming to work there. OWR will be available for the tax year that they become UK resident and the following two tax years on duties performed wholly outside the UK for a non-UK employer. The relief will operate by applying the remittance basis to such employment earnings.

Changes to the remittance basis

Inadvertent remittances

Finance Act 2013 made some minor but necessary changes to the remittance basis of taxation. Where a non-domiciled taxpayer brought funds to the UK to make a payment on account of income tax, this could previously have constituted an inadvertent remittance of the funds, resulting in a further tax charge. The unfairness of this result led to s21 Finance Act 2013 (which inserted s809UA in the Income Tax Act (ITA) 2007), so that in limited specified circumstances the payment on account will no longer constitute a remittance from the 2012/13 tax year onward.

Exempt property

The categories of exempt property for the purposes of the remittance basis were also extended slightly in Finance Act 2013. Property that qualifies as exempt does not give rise to a remittance when it is brought into the UK by a remittance-basis user. Again, the amendments were made to address an unfairness in the way that the previous rules worked. If exempt property that had been brought into the UK was stolen, lost or destroyed while in the UK, a remittance could arise at that point. Sections 809Y and 809YA ITA 2007 (s20 and Sch. 7 Finance Act 2013) have amended this position such that exempt property that is lost, stolen or destroyed while in the UK will not cease to be exempt property as a result. If the property is recovered and sold or if compensation is received, a remittance may then arise. Consequent changes were made to the temporary importation and public-access rules to reflect this relaxation.

Amendments to UK offshore taxation regime in response to EU intervention

In February 2011 the European Union indicated to the UK Government that it was concerned that certain aspects of the UK legislation on the taxation of offshore structures were not compatible with the EU rights to freedom of establishment and the free movement of capital. The UK Government indicated its intention to address this legislation, but the pressure was maintained by the EU, resulting in a referral to the European Court of Justice in October 2012.

The legislative amendments eventually came about in Finance Act 2013, which made changes to the rules by which the chargeable gains of an offshore company may be attributed to a shareholder of that company (s13 TCGA 1992[6]). These rules also apply to attribute the gains to non-resident trustee shareholders and, in turn, potentially to the beneficiaries as trust gains.

The attribution-of-gains rules apply only where the company would be a close company if it were UK resident – generally when it is under the control of five or fewer participators. The apportioned gains of a non-resident company that would constitute a close company if it were UK resident can be attributed to the participator of the company and taxed as his or her personal gains. Before 6 April 2012, this attribution could take place only if the participator owned at least 10% of the company. The new rules increase the

6 Taxation of Chargeable Gains Act 1992; the equivalent Irish section is s590 TCA 1997.

attribution threshold to 25% and provide a transitional rule for the year 2012/13 for those who make an election for the old rules to apply. In addition, from 2013/14 the now codified split-year rule applies to a participator who is non-resident for only part of the year. The amendments to the rules also expanded the categories of assets that are excluded from the attribution-of-gains rules, most notably to exclude assets used for economically significant activities outside the UK or where there was no tax-avoidance motive in purchasing or selling the asset.

To counter the EU attack on the UK transfer-of-assets-abroad legislation in s720 ITA 2007,[7] a new exemption for "genuine transactions" has been introduced. The existing legislative exemptions were generally considered by most practitioners to be largely unobtainable, and it remains to be seen how the new exemption will fare by comparison.

Clampdown on offshore employment intermediaries

In Budget 2013 the UK Government announced its intention to clamp down on the use of offshore employment intermediaries to avoid employment taxes. After consultation, provisions have been included in Finance Bill 2014 with intended effect from 6 April 2014. Essentially, the UK agency that contracts with the UK end-client will now be responsible for the collection of tax and national insurance contributions via PAYE.

Taxation of UK Residential Property

"Three-pronged attack" on corporate ownership structures

Finance Act 2013 also saw the introduction of the remaining components of a package of measures announced in March 2012 that were designed to prevent the use of companies as "envelopes" to hold high-value residential properties (See also more detailed article in this issue by Aoife Walsh). To recap briefly, the changes were three-fold:

- the introduction of a new 15% rate of stamp duty land tax (SDLT) on the purchase by a company or other "non-natural person" (NNP) of a property for more than £2m;
- the introduction of an annual charge of between £15,000 and £140,000,[8] now known as the annual tax on enveloped dwellings (ATED), on properties worth more than £2m owned by NNPs; and
- the extension of CGT to gains realised by NNPs on the disposal of properties for more than £2m, now known as ATED-related CGT.

In response to concerns raised during the consultation period about the economic impact of the changes, a "business relief" was incorporated in the final legislation. The relief exempts from all three "prongs" properties that are used for "business purposes" and that are not occupied by "connected persons" (the definition of which is extremely wide). Qualifying business purposes include property rental businesses, property development businesses and working farmhouses.

Extension of rules announced in 2014 Budget

In the 2014 Budget the UK Government announced that properties valued at over £1m will be brought within the scope of ATED from 1 April 2015 and properties valued at over £500,000 will be brought within it from 1 April 2016. From the latter date, the annual charge will range from £3,500 to £140,000 (as indexed for inflation). The ATED-related CGT will be extended in line with the annual charge, to apply to all residential properties worth over £500,000 owned by NNPs from April 2016.

Extension of CGT to non-residents

In the 2013 Autumn Statement the Government also announced the extension of CGT to non-residents disposing of UK residential property, which is proposed to take effect from April 2015 (with the charge applying to gains arising after that date). This alteration is in reaction to a perceived unfairness in the fact that UK residents pay CGT when they sell a home that is not their primary residence but (currently) non-residents do not. Unlike under the ATED regime, the Government believes that gains made on investment property should also be subject to CGT, and it has not proposed an equivalent of the "business relief" for the extended CGT charge.

The Government acknowledges that this is a significant change, and it is currently undergoing a consultation process to refine the scope and structure of the new regime. Of particular concern in the current proposals is the potential removal of the ability to elect which of two or more residences is to be treated as a taxpayer's

7 The equivalent Irish section is s809 TCA 1997.
8 The annual charge will increase each year by reference to the Consumer Price Index. The range of charges for the period beginning on 1 April 2014 is £15,400 to £143,750.

main residence and therefore receive relief from tax. If this ability were retained, it could be expected that non-residents would make an election for their UK property to be treated as their main residence and thereby avoid the CGT charge. It is thought that the removal of the election will have to be universal so that the new provisions do not fall foul of EU law. Both UK and non-resident taxpayers would therefore be unable to make such an election. The Government is consulting on the criteria to be used to decide which residence qualifies for the relief in the absence of an ability to elect.

Estate Planning

Changes to spouse exemption for non-UK-domiciled persons

Before 6 April 2013, where a UK-domiciled (or deemed domiciled) individual made a transfer of value to a non-UK-domiciled spouse, the available spouse exemption for inheritance tax (IHT) purposes was limited to £55,000. This exemption has been increased to £325,000 from 6 April 2013, but it remains a severe restriction for individuals with substantial estates. Under changes brought in by Finance Act 2013, an election can now be made for the non-domiciled spouse to be treated as UK domiciled for IHT purposes, in order to benefit from the full spouse exemption.

However, the IHT disadvantages for the non-domiciled spouse must be balanced against the potential advantages of making the election. If the non-domiciled spouse elects to be treated as UK domiciled for IHT purposes[9], that spouse's worldwide estate will be taxable at 40% on death, subject to the nil-rate band and any available exemptions and reliefs. Effectively, the non-domiciled spouse will be bringing his or her non-UK-*situs* assets into charge. There may also be an impact on the taxation of lifetime gifts, with gifts into trust being subject to an immediate 20% charge and outright gifts being subject to tax if the electing non-domiciled spouse dies within seven years of making them.

The election cannot be revoked once it is made, although if the non-domiciled spouse is not resident in the UK for income tax purposes for four successive tax years beginning at any time after the election is made, the election will cease to have effect at the end of that period.

Example

Seamus and Mary are an Irish couple living in the UK. Seamus has been resident in the UK for more than 17 years, which has caused him to become deemed domiciled in the UK for IHT purposes. His worldwide assets are exposed to IHT. Mary has been living in the UK for only five years, so she is not yet actually or deemed domiciled and only her UK assets are exposed to IHT.

If Seamus dies first, the limited spouse exemption of £325,000 will be available on assets passing to Mary. The balance of assets passing to her will be taxable at 40% to the extent that the value exceeds Seamus's nil-rate band of £325,000 (which is available in addition to the spouse exemption).

Mary could elect before, or within two years of, Seamus's death to be treated as UK domiciled for IHT purposes. This would allow all assets passing to her (whether outright or on life interest trust) to pass free of IHT. However, Mary's worldwide assets would then be brought within the IHT net.

If Mary returned to Ireland after making the election, she would lose the elected UK domicile status (and her IHT exposure would reduce again to her UK assets only) after four tax years of non-UK residence. This four-year "risk period" could be covered by term life insurance if it was a concern.

Restrictions on the deductibility of debts for IHT purposes

As a general rule, IHT is charged on the **net** value transferred by a chargeable transfer. However, Finance Act 2013 introduced changes to restrict the deductibility of debts in certain circumstances.

Debts used to finance excluded property

As noted above, the non-UK assets of a non-UK-domiciled individual are not subject to IHT. For this reason, they are termed "excluded property".[10]

One of the new restrictions placed on the deductibility of debts relates to cases where borrowed funds are used to finance excluded property. In the past, it has been fairly common planning for non-UK-domiciled individuals to borrow against the value of their UK property and invest the borrowed funds offshore. The Government perceived this as abusive and has introduced these

9 The election will not affect the individual's UK income tax or CGT position.
10 Section 6 Inheritance Tax Act 1984 (IHTA 1984).

restrictions to prevent it. The restrictions apply to deaths/transfers on or after 17 July 2013, irrespective of when the liability was incurred.

In order to prevent the new rules being unduly restrictive, exceptions are made where the excluded property has subsequently been disposed of in exchange for chargeable assets, where the property is no longer excluded property or, to an extent, where the excluded property has reduced in value.

Nonetheless, UK-resident non-UK-domiciled (RND) individuals can still engage in planning with excluded-property trusts. Broadly, by transferring their non-UK assets into trust before becoming deemed domiciled, RNDs can shelter those assets from IHT and that protection will be preserved even after they become deemed domiciled in the UK.[11]

Discharge of debts on death

Under the new rules, when calculating IHT liability on death, debts will be deductible only to the extent that they are discharged on or after death out of the estate[12] of the deceased. The purpose of the new rules is to prevent the deductibility of debts that will never actually be repaid, such as loans from family members that are waived on death. Exceptions apply where there is a "real commercial reason" for the debt not being discharged (provided that securing a tax advantage is not the main purpose, or one of the main purposes, of leaving it outstanding). An example of this may be where a property is subject to a mortgage with a commercial lender and a beneficiary takes over that mortgage after the death.

UK's Continued Crackdown on Tax Avoidance

General anti-abuse rule

Future tax planning arrangements will need to be considered in light of the GAAR, which came into effect on 17 July 2013. The GAAR is designed to plug perceived gaps in existing tax legislation and render ineffective arrangements that are considered "abusive". The question of what constitutes abuse will be left to the court to decide, assisted by the recommendations of a specially appointed advisory panel. HMRC has published guidance on the application of the GAAR, including numerous examples of the types of activities that will be considered abusive. However, clear guidance is offered only in the most extreme cases, leaving a significant grey area to be navigated. Until precedents have been established by the courts, careful judgements will be needed to assess whether proposed arrangements are likely to be within the scope of the GAAR.

2014 Finance Bill changes

The 2014 Finance Bill marked an apparent sea change in the approach of HMRC to taxpayers who are the subject of a tax enquiry. Previously, each case was dealt with on its own merits, and payment of disputed tax could be postponed until the enquiry reached its end. HMRC identified that there were many cases where the decision in a representative case should be decisive of many individual enquiries, but it did not have a mechanism to apply the ruling more generally. In addition, it was considered that payment of the disputed tax should not be delayed while the enquiry was resolved. These two issues have been addressed by the introduction of Follower Notices (FNs) and Accelerated Payment Notices (APNs).

The FN and APN legislation will have effect from the date of Royal Assent of Finance Bill 2014 (expected to be in July) and will be applicable to all cases where there is an open enquiry or appeal at that date. These measures apply to income tax, capital gains tax, corporation tax, inheritance tax, stamp duty land tax and annual tax on enveloped dwellings.

Follower Notices

HMRC will have the power to issue FNs where a "final judicial ruling" has found that the disputed tax arrangements did not have the effect claimed by the taxpayer. These notices can be issued when there is already a tax enquiry or appeal under way, and it is a question of HMRC's opinion on whether the judicial ruling is applicable in the taxpayer's case. Once HMRC has issued the notice, taxpayers have 90 days in which to submit written representations if they do not believe that the judicial ruling is applicable to their case. HMRC may confirm (with or without amendment) or withdraw an FN based on the taxpayer's representations.

If a taxpayer does not respond to an FN by amending his or her claim/return or by taking steps to enter into a written agreement with HMRC, penalties at 50% of the "denied advantage" will be applied. The penalty may be reduced to a minimum of 10% of the "denied advantage" if the taxpayer cooperates with HMRC.

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11 Section 48(3) IHTA 1984.
12 For the purposes of these rules, any excluded property will be regarded as forming part of the deceased's "estate".

Accelerated payments

HMRC will have the power to issues APNs where there is an enquiry or appeal in respect of a taxpayer's return or claim if:

- HMRC has also issued an FN in respect of that return or claim, or
- the return or claim concerns DOTAS (Disclosure of Tax Avoidance Schemes) arrangements, or
- a GAAR counteraction notice has been issued in respect of the arrangement.

The amount required under an APN is the amount considered to be the "understated tax", and it is treated as a payment on account of the understated tax.

On receipt of an APN, the taxpayer has 90 days in which to make written representations. Again, HMRC will decide whether to confirm (with or without amendment) or withdraw the APN based on the representations.

Fixed-rate penalties will apply if the payment requested in the APN is not made within the required period (generally 90 days after the APN) at 5% of the underpaid amount on the day that it becomes overdue, when it has been overdue for five months and when it has been overdue for 11 months.

Significant concerns have been raised by commentators and advisers in the UK about the impact that this change of approach will have on the relationship between taxpayers and HMRC. It remains to be seen whether any concessions to these views will be made before the legislation comes into effect later this year.

The Winds of Change Blow on

As can be seen from this article, the landscape for advising UK-connected private clients remains complex and ever-changing. This article seeks to raise awareness of issues that may be relevant to Irish clients with UK connections, but specialist advice should always be sought in individual cases. Finance Bill 2014 is not expected to receive Royal Assent until July 2014, and amendments may be made to the draft legislation before Assent is received. This article reflects the current version of the Finance Bill at the time of writing.

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