

# focus

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frank hirth plc  
international tax and accounting services

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Welcome to our latest edition of Focus which we had thought would be very early in the New Year with changes in the proposed Pre-Budget Report having been clarified. Well, we certainly do address this, building on our first views on the proposals at the end of January, but as the consultation period finishes, matters remain far from clear!

On 18 January 2008, draft legislation was published for consultation with regard to the wide-ranging changes suggested in Mr Darling's pre-budget report for non-domiciled individuals residing in the UK.

An open letter was then received from HM Revenue & Customs Chairman, Mr Hartnett. This is discussed briefly in this edition of Focus and since its release there has been further commentary that this clarification has been misunderstood.

Given the significant impact this new legislation is going to have on the majority of our client base, and the level of uncertainty surrounding it, we are going to look at the proposed legislation in more detail in this edition of Focus to help raise some of the thorny issues that can arise and start the process of obtaining professional advice before the new legislation is implemented.

We urge any of our clients and friends who are likely to be impacted by these changes to contact us as a matter of urgency to discuss their own circumstances to ascertain how significant these changes will be to them personally.

We will also be looking at the draft legislation introduced on 24 January 2008 with regard to the new rate of capital gains tax of 18% effective from 5 April 2008, and the introduction of the 'Entrepreneurs Relief' highlighted on the same day.

Over the last three months our dedicated and enthusiastic staff have worked tirelessly to file an extremely large number

of US and UK tax returns before the filing deadlines of 17 December 2007 and 31 January 2008 respectively. The company owes a great deal of gratitude for all the time and effort that everyone has put in over this period and would like to extend a huge thank you to you all.

There has been plenty of news from within the firm over the last five months, which has seen many new faces and sadly some old ones departing. After ten years with the firm we were sad to say goodbye to Daniel Hyde, who had worked through the ranks to Senior Manager before departing. Similarly, we sadly said goodbye to Tugrul Marashli and Jan Ditchburn who had been at the company for nine and nineteen years respectively and contributed an enormous amount to the growth of the company during their time here. We also said goodbye to Claire Cooper from the Audit department, Melissa Creasy, Shumiraya Musungwa, and Sonia Malik from our tax team and Jennifer Howell and Donna Lambert from our administration support.

On a positive note we have seen twenty-four new faces join us in the last three months! As you will remember from the September edition, we were in the process of recruiting a large number of new graduates as part of our graduate training programme. They have now started with us and they are Mark Allsopp, Jonathan Brown, Tahir Mahmood, Fiona McManus, Thomas Morris, Tracy Ng, Matthew Pannell, Stela Pici-Hall, Kelly Ricketts, Adam Rose and Alex Straight. We are also delighted to welcome Stephen Asher as Senior Manager. Stephen has worked in the industry for over twenty years and will help develop and complement our compensation and benefits team with his significant experience and expertise. Donal O'Brien joins us as an experienced manager specialising in UK trusts, whilst Karin Ljunggren joins us as a senior dual handler of UK and US personal tax affairs, and Kader Mohideen and Caroline Pepin join us as experienced tax professionals predominantly dealing with US personal and corporate tax. Simon Mendes has joined our Audit department as an accounts assistant. We have also welcomed Gemma Pattenden to the secretarial team, Lewis Cromwell and Kim McGhee to our database team, Sarah Jones to our reception team, Sara Ahmed to our internal accounts department and Emma Beechey and Amy Townsend as Client Support Assistants. We look forward to working with them all.

Congratulations have been passed on to Alison Hibbs and Nargis Khan for passing their final ACCA exams and becoming fully qualified in June 2007 and December 2007 respectively, as well as to Kerry-Ann Keegan, Gareth Lambe and Lucy Townsend for passing their US Enrolled Agent exams in October 2007. We are also extremely pleased that both Sarjul Patel and Matthew Norris passed their full set of ATT exams in November 2007.

Last but by no means least, we are also delighted to announce that Rhea Lucia-Hennis, James Murray and Steven Cameron have all been promoted to Manager as of 1 October 2007. This news is particularly pleasing to the firm given that they all joined us as part of our first graduate recruitment drive.

Congratulations to you all.



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## AN OPEN LETTER FROM HM REVENUE & CUSTOMS CHAIRMAN

Following the publishing of the draft legislation, it was widely seen by professionals as considerably more far reaching in nature than had initially been expected. During the consultation period, HM Revenue & Customs (HMRC) have received responses (including from this firm) on the difficulties with their proposals particularly in the trust area. HMRC Chairman, Mr Dave Hartnett, sent an open letter on the proposals as the consultation period drew to an end.

Mr Hartnett addressed four issues that have been raised and that he "... wants to make clear what the Government's intention has always been and how it will be set out in the legislation to be brought forward".

The four issues that Mr Hartnett wished to clarify are as follows:

- Individuals using the remittance basis will not be required to make any additional disclosures as to the source of the income and/or gains they have subsequently remitted and paid tax on in the UK.
- There will be no retrospection in the treatment of trusts and the tax changes will not apply to gains accrued or realised prior to the changes coming in to effect (see below).
- Money brought into the UK to pay the £30,000 charge will not itself be taxable.
- It will continue to be possible to bring works of art into the UK for public display without incurring a charge to tax.

At present, further commentary is needed from HMRC but our current view on the last three points above is:

- The use of the word "accrued" in the second statement suggests that a valuation of the assets of each offshore trust as at 5 April 2008 may well be needed so as to ascertain, in relation to sales after that date, what gains had accrued prior to 5 April 2008 in order to correctly report any future gains being distributed from the trust. Since this 'clarification', the suggestion is that this is not what was meant and we should not presume exclusion of these accruals.
- This is not how the current legislation is drafted but is a welcome concession.
- This could have huge implications for individuals wishing to dispose of works of art via UK auction houses. If the work of art is brought in to the UK for sale and the funds are still left offshore, the seller may need to recognise a remittance as the equivalent to the fair market value of the works of art.

Plainly, it is unsatisfactory that the rule changes remain in such a state of flux and there are many conflicting steers.

Please get in touch with your usual contact at Frank Hirth to discuss any of the above proposals or concerns you may have.

## INTRODUCTION TO CASES

By now, you will have read our special publication – Taxation of UK Non-Domiciled Individuals. The consultation period draws to a close and we await Mr Darling delivering the Budget to the House of Commons on 12 March 2008.

Speculation will continue up to that point on whether any adjustments will be made to these wide ranging proposed changes. Rather than continue this speculation, we thought we may be able to raise some of the issues in the form of some case studies. Hopefully, this brings out a selection of issues that may be faced to help illustrate some of the possible consequences and act as a discussion point to a myriad of possible solutions.

You will need to focus on the particular circumstances you face with advisers, armed with your own specific fact pattern. It is not intended that any of the considerations raised in the studies are suitable to act on.

## CASE STUDY 1

### Circumstance

Mr A, a US citizen resident in the UK for ten years, holds a controlling interest in a UK trading company through an offshore company structure in the BVI.

Mr A holds a 40% interest in the BVI company. The remainder of the BVI company is owned equally by three non-UK resident and non-US national individuals, i.e. 20% each. The BVI company owns 100% of the share capital of the UK company.

- (a) The UK company is currently valued in excess of \$40m and it is envisaged that the shares in the UK company will be sold at some time in the future – are there any changes in the taxation treatment on sale in light of PBR changes? What, if any actions can be taken to improve the position?
- (b) What would the situation be if the BVI company was a US LLC instead?

### Considerations

There has long been anti-avoidance legislation to protect against UK tax avoidance involving such structures centred on income tax and capital gains tax but the latter has only applied to UK domiciled persons. We will not discuss the income tax implications any further here but please contact your tax manager for more detail if desired.

Currently, where a UK domiciled and resident individual is holding an interest in a foreign company (where it would be considered to be a "closely held company") then any capital gains arising to the foreign company in respect of UK assets will be deemed to arise directly to the individual in proportion to their ownership in the foreign company. This applies irrespective of whether or not any distributions of proceeds from the sale were made to the individual, who would then be subject to UK tax on the attributed gain in the same manner as any other personal capital gain.

For this purpose, a "closely held" company is one which is under the control (in general >50% share holding), of five or fewer persons (a persons holding also includes the holding of any connected person).

If Mr A, together with one of the other owners, holds 60% of the BVI company the BVI company would meet the "closely held" test.

The new legislation proposes to extend this capital gains tax anti-avoidance measure to individuals like Mr A who are not domiciled but resident in the UK, irrespective of whether the proceeds are even distributed by the foreign company let alone remitted or deemed remitted to the UK.

There is no "bona-fide commercial" escape clause under these proposals as can be seen with the income tax anti-avoidance legislation.

- (a) Mr A is not domiciled in the UK so the current anti-avoidance on capital gains would not apply, and as the BVI company is not subject to UK capital gains tax then no UK taxation arises on the sale of the UK company if it takes place before 5 April 2008.

However, if the disposal occurs after 5 April 2008, then the proposed legislation will generate a charge to UK capital gains tax on Mr A at the date of disposal without regard as to whether there is any remittance.

(b) For the purpose of this new legislation, a US LLC is not considered any differently to an offshore corporation.

Where tax arises in another country on the same transaction, e.g. the US, then consideration is required with regard to the matching of tax credits to avoid potential double taxation. This may be problematic in some cases so specific advice is required.

It should also be noted that these changes also apply to non-resident landlord corporations owning UK real estate. Non-UK companies may continue to be beneficial for income tax and other practical/legal reasons but any capital gain arising on the sale of the UK property may now be subject to UK capital gains tax.

### Action to be Taken?

Review on a case by case basis is required as the facts and circumstances surrounding the structure will vary considerably, along with any overriding non-tax issues to consider.

Ideas being considered range from simple sale of the UK assets before 5 April 2008; constructing forward sale arrangements whereby the tax point is triggered pre-5 April but the actual realisation point is deferred; ensuring the offshore corporation does not meet the definition of a "closely held" corporation. The latter is likely to be used more as a planning tool for new structures than as a solution for existing ones. There has also been some discussion as to whether certain double taxation treaties offer any protection against this legislation.

## CASE STUDY 2

### Circumstance

A US citizen, Mr X, has been resident in the UK for seven years. The individual is married to a UK citizen with children. They have their home here which, for career reasons and the children's education, now means they will remain here for the next few years.

The individual has exhausted untainted funds and has a substantial offshore mortgage. It has suited them to fund interest commitments on the mortgage without a remittance problem from offshore funds. They aim to settle the loan after leaving the UK. The individual needs to consider a method for bringing family wealth onshore but recognises the current problem of the mix of gains and other investment income which taints the funds.

Prior to the pre-budget announcement, a number of assets with large accumulated capital gains were settled in trust. The plan was to look for capital growth in the trust to guard against other remittance problems and, for gains to be realised in the future which could be remitted freely and used to settle the offshore mortgage etc without UK tax implication.

What steps should he take in the light of the PBR?

### Considerations

(a) The proposed changes in the taxation of non-domiciliaries seeks to broaden the attribution rules so as to first attribute the trust gains to settlors with interests in their non-resident settlements. Any gains on UK assets within the trust will, in future, be taxable as realised. With regard to gains on foreign assets, it is proposed following the 12 February 2008 clarification these will be taxable on the settlor on a remittance basis. Additionally, the proposals widen the attribution of gains to resident but not non-domiciled beneficiaries on a worldwide basis irrespective of whether remittances are made.

### Factors to Consider Include:

- (b) The trust appoints all capital out of trust before tax year-end.
- (c) Remitting all gains (if any) within the trust prior to year-end to fund living requirements in the UK providing funds to potentially repay the offshore mortgage if staying longer-term and the impact of future interest payments on the mortgage becoming taxable remittances. Watch risk of attributions of gains to capital payments on beneficiary interested foreign trusts post 6 April (and accrued gains pre-6 April may still be caught in the same way).
- (d) Break the trust and distribute all assets. If Mr X is here for work and children's education years, but unclear on future plans, should he consider the benefit of assets within offshore trust for inheritance tax purposes; would it make sense to move some assets outside trust structure but leave some assets within trust as excluded property?

## CASE STUDY 3

### Circumstance

Mr Z is a US citizen partner of a private equity group.

The individual carry and co-investment participation in funds is held through an offshore trust structure with significant unrealised gains built up.

He has only been here in the UK for three years or so; he is not concerned given he may leave the UK prior to the seven year point. On the other hand, there is a chance he may stay, in which case he will want to bring his funds onshore as effectively as possible.

### Considerations

(a) see 'case study 2' considerations regarding offshore trusts

Seven years is therefore not the key consideration for any existing planning and arrangements. They will need to be reviewed both in terms of the structure of the trust and what assets form a part.

(b) Individual planning and circumstances surrounding the structure must be reviewed; ideas may include:

- Trust appointing all capital out of the trust before tax year-end to individual, be aware of inheritance tax consequences and whether this is sensible.
- By sale or liquidation of certain assets within a structure, a step-up in basis may be achievable. However, this carries caution about the order and timing of the steps and the risk of being taxed on distributions after 6 April 2008 from gains as a resident beneficiary of a foreign trust.
- Become non-resident of the UK (with recognition of the new day count rules that will apply from 6 April 2008).

## CASE STUDY 4

### Circumstance

Non-domiciled taxpayer Mrs Y, a US citizen, has been resident in the UK for ten years. The individual is a partner in a US law firm and expects to remain in the UK for many years. Mrs Y is reconciled to the fact that she will remain here because of career demands and ideally wants access to funds as years go by.

The taxpayer has actively sought to separate out original principal and UK post-tax income (which can be freely remitted) from other sources which have offshore income and gains and which carry with them a 'taint' (taxable in the event of remittance here).

She has significant unremitted foreign partnership income and other gains accumulated from years prior to 2007/08, and wants some ideas about issues to consider in the light of the proposed changes in this area.

## Considerations

- (a) Understand the benefits or otherwise of electing the remittance basis and paying £30,000 as opposed to being taxed on the arising basis.
- (b) Consider her portfolio of investments in due course to understand if she is to be taxed on the arising basis; ensure items of offshore investment will not be treated as income or gain at a different time in the US and UK or, as capital gains in one jurisdiction and subject to income tax in another.
- (c) Consider the arising basis of taxation and work with advisors in the period to the end of tax year to see whether further comfort can be found against the prospect of potentially not being able to credit actual UK tax suffered under this new proposed legislation.
- (d) Reflect whether choosing the arising basis of tax in 2007/08 and other actions with accumulated offshore funds before year-end better prepares the taxpayer for a future regime as proposed.

## CAPITAL GAINS TAX REFORM

Another major change proposed by Alistair Darling in his first pre-budget report in October 2007 was to introduce a flat rate of 18% for Capital Gains Tax (CGT). On 24 January 2008 the Chancellor confirmed the proposals of his pre-budget report and the only concession he made following considerable lobbying on behalf of small businesses was that there would be a new 'Entrepreneurs Relief' on the first £1m of gains realised by some entrepreneurs.

The draft legislation issued on 24 January 2008, will:

- introduce a single rate of CGT of 18%
- abolish indexation allowance
- abolish taper relief
- make rebasing of cost to 31 March 1982 compulsory
- simplify the rules for matching certain assets (mainly shares) disposed of with assets acquired

The changes affect individuals, trustees and personal representatives with a gain chargeable to capital gains tax. They do not apply to companies that are liable to corporation tax in respect of their chargeable gains.

The changes will not affect the availability of the annual exemption, currently £9,200, which will increase from 6 April 2008. Other reliefs such as private residence relief, business asset roll over relief, EIS and VCT reliefs, business asset gift relief and losses from previous years will continue to be available.

### Entrepreneurs Relief

The Chancellor also announced a new relief, 'Entrepreneurs Relief' which will take effect from 6 April 2008 alongside the changes above. The relief will be available in respect of:

- Gains made on disposal of all or part of a business.
- Gains made on disposals of assets following cessation of a business.
- Gains made by certain individuals involved in running the business.

The first £1m of gains that qualify for relief will be charged to CGT at an effective rate of 10%. Gains in excess of £1m will be charged at the rate of 18%. In practice, the relief will work whereby individuals will be able to make claims for relief on more than one occasion, up to a lifetime total of £1m of gains qualifying for relief.

The relief will effectively reduce gains liable to CGT at the single rate of 18% by 4/9ths, resulting in an effective 10% rate (5/9ths x 18%).

For example, if the sale of a business realises £450,000 gains, the gains will be reduced by 4/9ths (£200,000) and £250,000 will be liable to 18% CGT (subject to deduction of any allowable losses and annual exempt amount) giving a tax charge of £45,000 (an effective 10% rate on a gain of £450,000).

Generally, 'Entrepreneurs Relief' will be available where relevant conditions are met for a period of one year as follows:

- Relief applies to gains arising on disposals of whole or part of a trading business (including professions and vocations, but not including property letting businesses other than furnished holiday lettings) carried on by an individual either alone or in partnership.
- Where a business simply ceases, relief is available on gains on assets formerly used in the business and disposed of within three years of cessation.
- Relief also applies to gains on disposals of shares and securities in a trading company provided the individual making the disposal has been an officer or employee of the company and owns at least 5% of the ordinary share capital which enables the individual to exercise at least 5% of the voting rights in that company.
- Where an individual qualifies for relief on disposals of shares and securities above, relief will also be available in respect of any "associated disposal" of an asset that was used in the company's business e.g. where a company director owns the premises from which the company operates. Relief is restricted where the asset is not wholly in business use throughout the period of ownership.
- Similarly, a member of a partnership who is entitled to relief on disposal of his interest in the assets of the partnership will be allowed relief on an "associated disposal". Again, relief will be restricted where the asset is not wholly in business use throughout the period of ownership.
- Trustees will also be able to benefit from relief on gains and assets used in a business. In order for trustees to benefit, a beneficiary of the trust with an interest in possession relating to those assets must be involved in carrying on the business in question, personally or as a partner.
- In the case of shares, a beneficiary must qualify as an officer or employee of the company in question.
- The £1m maximum limit on eligible gains will apply to the trustees and the qualifying beneficiary jointly.

If you have any concerns and would like to discuss these changes, please get in touch with your usual contact at Frank Hirth.