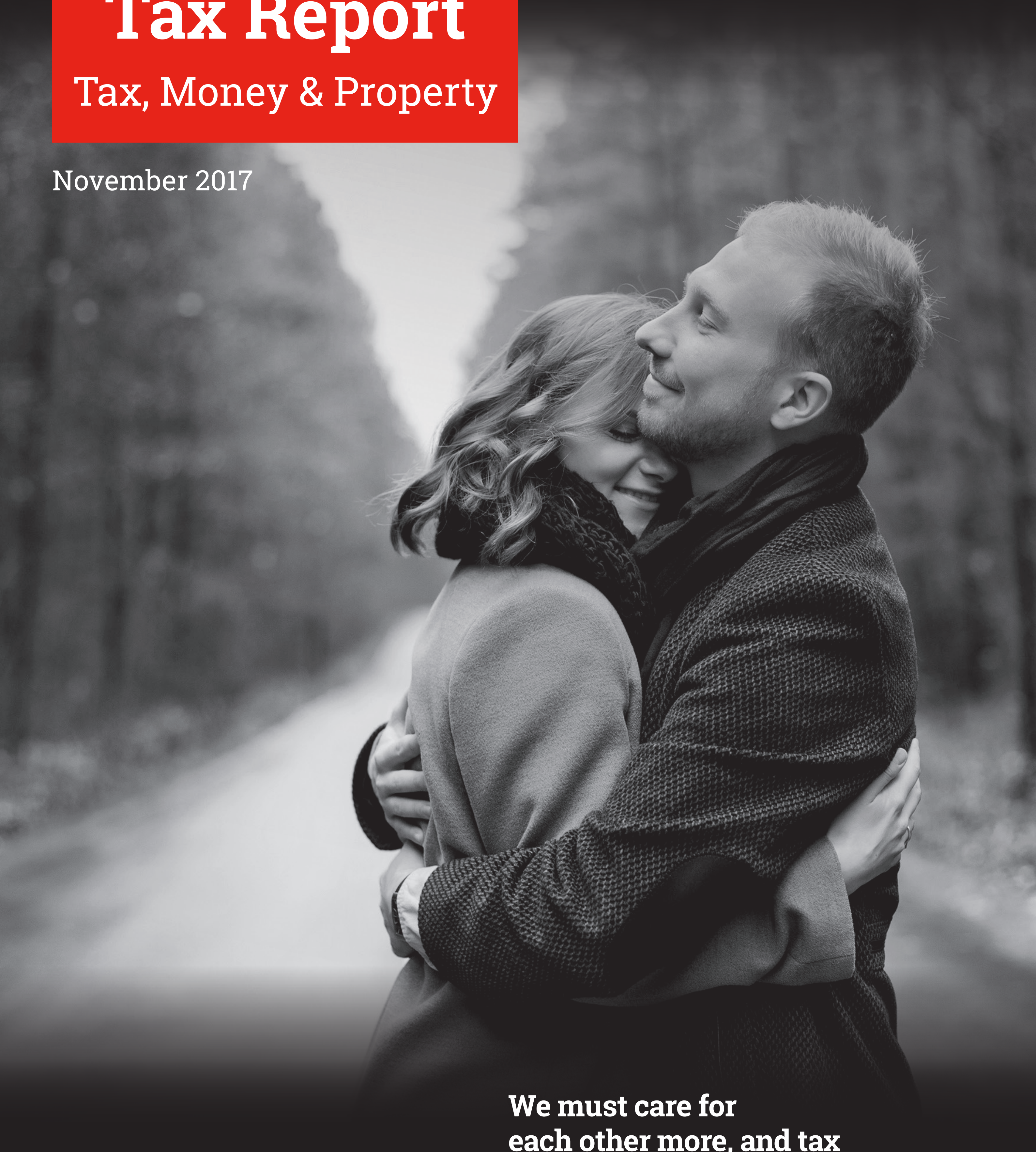
The Schmidt Tax Report

Tax, Money & Property

November 2017



We must care for each other more, and tax each other less -*Bill Archer*

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Tax

News

The Paradise Papers

A new leak concerning offshore holdings, trusts and activities has occurred. Dubbed the Paradise Papers, it is a database comprising around 13.4 million documents detailing the tax affairs of some of the wealthiest people and companies in the world. The majority of the data comes from papers stolen from Appleby, a Bermuda-based law firm specialising in offshore accounts. Nearly 100 media organisations have been involved in sifting through the tranche of files, which were obtained by German newspaper *Süddeutsche Zeitung* and shared with the International Consortium of Investigative Journalists (ICIJ).

Transparency International attacks UK

Hundreds of British shell companies are implicated in nearly £80bn of money-laundering scandals, according to Transparency International UK, a non-governmental organisation, which announced in early November that the UK was home to a network that operated much like the companies at the heart of the Paradise and Panama papers. Duncan Hames, director, said: "As fingers point to jurisdictions like Panama and Bermuda, it shames the UK that companies are being set up under our noses, with the sole purpose of laundering illicit wealth; money very often stolen from some of the poorest populations in the world, starving them of vital resources." Opposition MPs renewed calls this week for the government to force the British Overseas Territories and Crown dependencies to adopt the UK's system of providing public access to information about who really controls which companies.

EU warns tax havens

The EU has instructed 53 countries and territories that they risk being blacklisted as tax havens after the UK earlier delayed warnings to a dozen jurisdictions with ties to Britain. Brussels advised 41 countries that they would be blacklisted unless they promised to change their tax rules, according to people close to the talks. But British concerns caused the EU to hold back from delivering similar warnings to 12 more jurisdictions including Bermuda, the Isle of Man and Cayman Islands – what one official called the "usual suspects". London changed its stance late last week, two days before the Paradise Papers leak put the issue of global tax legislation back in the spotlight. The European Council, made up of EU member states, started analysing non-EU countries last year to decide whether they should be designated as tax havens, sending inquiry letters to 92 jurisdictions in February after initial screening.

Low on fuel

The Office for Budget Responsibility has announced that it expects receipts from fuel duty to drop from 5% to just 1% of GDP between now and 2030. Currently, fuel duty generates £27.9 billion a year for the government, with an additional £5.8 billion raised from vehicle excise duty and £200 million from a levy on heavy goods vehicles. This revenue is under threat as cars become more fuel-efficient and electric vehicles (which are exempt from nearly all taxes) become more popular. Road pricing, whereby the actual cost of running the road system (congestion, wear and tear, investment in new roads, etc.) is imposed upon drivers, has never been adopted in the UK, as it is so unpopular with the public. However, as the *Financial Times* has recently pointed out: "Politicians may not be able to avoid the issue for much longer if they want to avoid losing even more government revenue."

Adjudicator's Office annual report

The Adjudicator's Office has published its 2016/17 report in which it states that it received a total of 9,015 enquiries during the year and accepted 1,142 new complaints for investigation. Only six of the cases it is currently investigating are more than 12 months old. The percentage of complaints against HMRC upheld by the Adjudicator fell to 41%, compared to 73% last year and 85% the year before. It would appear that the nature of the complaints has changed, HMRC is behaving better or the Adjudicator is showing bias.

HMRC offers help to mid-sized businesses

HMRC has launched a new service to assist medium-sized businesses as they expand and grow. The service is aimed at organisations with a turnover of £10 million a year or more and with at least 20 employees. The object of the service is to help with tax queries, supply accurate information and coordinate technical expertise from across HMRC, and support taxpayers to get their tax right first time and access relevant incentives or reliefs. Although the new service has been cautiously welcomed by the leading accountancy firms, many questioned how effective it would be given that there are some 170,000 UK companies in the '£10 million plus' bracket.

HMRC backs down

HMRC has conceded that lorry drivers will not have to produce receipts to cover the exact cost of the overnight allowance paid to cover subsistence when they are sleeping in their cabs on longhaul trips. Evidence will still have to be supplied of expenses, but other means such as digital photographs on a smartphone will be acceptable.

The Finance Bill 2017

The diverted profits tax (DPT) revenue (also known as the Google Tax) collected by HMRC in 2016/17 totalled £281 million, leaping from £31 million collected in the previous year, according to data released by the government. Introduced in April 2015, DPT aims to discourage multi-national companies using aggressive tax-planning structures to divert taxes from the UK.

HMRC loses to Sports Direct

The latest version of the Finance Bill for 2017 is currently working its way through Parliament. It contains five main areas of change: the non-domicile rules, disguised remuneration, Making Tax Digital, avoidance and evasion, and corporation tax.

The new non-domicile rules mean that a UK-resident non-domicile individual will become UK deemed domicile for both income and capital gains tax (CGT) purposes when they have been resident in the UK for 15 of the previous 20 years or whenever they are resident in the UK, if they were born in the UK with a UK domicile of origin.

The bill contains changes to the rules on employment income paid through third parties and trading income paid through them (aka disguised remuneration). In particular, there are provisions relating to loans and quasi-loans made after the 6th April 1999 that remain outstanding as of 5th April 2019. There is an anti-avoidance provision to stop contrived repayment arrangements.

Although the Making Tax Digital programme will not be introduced yet, the legislation allowing the government to proceed with its plans will be introduced as part of the bill.

There are several new measures in relation to avoidance and evasion of which the most worrying is that if HMRC can show that a taxpayer had a tax-avoidance motive they will also be presumed to have been careless as opposed to have taken reasonable care. Nor will they be able to avoid a penalty if they have acted on the advice of an interested adviser, whose advice will be treated as disqualified. There is also legislation designed to make individuals with historical offshore tax non-compliance to correct this before the 30th September 2018. After this there will be a 200% fine.

Corporation tax has also been subject to new changes, particularly in relation to corporate losses. The government wishes to limit the tax relief for loss set-offs if a company has significant profits but also plans to relax some of the rules around the carry forward rules allowing a more flexible set-off environment.

Tax fraud worth £5.2 billion

HMRC has announced that in the last year it has recovered close to £5.2 billion as a result of work carried out by its tax fraud unit. The Fraud Investigation Service (FIS) retrieved £2.36 billion through civil investigations and a further £1.07 billion through criminal investigations. HMRC said that its prosecutions last year led to more than 800 years of prison sentences and a further 200 years of suspended sentences.

VAT threshold brings business slowdown

Paul Morton, tax director of the Office of Tax Simplification, says that many small businesses are taking active steps to keep their turnover below £85,000 in order to avoid having to register for VAT. He offered examples including shops that closed for a month, bed and breakfast businesses that decided not to let extra rooms and plumbers who went on extra holidays to avoid VAT. The core issue is, apparently, that many companies selling to consumers often have to absorb the extra VAT charge as they are competing with rivals whose sales are below the threshold. The current situation means that a trader could be £17,000 worse off after crossing the threshold and this serves as an impediment to growth. The UK already has one of the highest VAT thresholds in the world. Most European countries operate on a threshold of around £50,000.

Parliament worried about VAT-free Uber

The Public Accounts Committee has criticised HMRC for failing to investigate Uber's approach to VAT. Uber has always said that it is under no obligation to collect VAT on rides because it only acts as an agent for self-employed drivers, rather than as a service provider. However, last year the British courts found that Uber's 30,000 drivers in London are workers rather than self-employed contractors. As a result, Parliament feels that Uber should be charging VAT to its customers.

Controlled Foreign Companies rules under attack

The UK's Controlled Foreign Companies (CFC) rules are being investigated by the European Competition Commissioner. In particular, Brussels wishes to question the group financing exemption, a rule that allows UK parent companies to avoid paying tax on interest paid on loans to their subsidiaries when that interest is paid into an offshore jurisdiction. Without the measure, that interest income would be taxed in the UK because CFC rules would ignore the offshore shell and allocate the interest income to the UK parent company. It is believed that multinationals have managed to avoid paying as much as £5.8 billion in UK corporate taxes a year by booking profits in overseas entities.

HMRC enjoys record receipts

HMRC received an additional £35.6 billion during the last tax year, up by 6.75% on receipts from the previous year. This is the highest level of year-on-year growth since 2008. It has been driven largely by taxes that target wealthy individuals with CGT up by 19%, national insurance (NI) contributions up by 10%, stamp duty land tax (SDLT) up by 10% and inheritance tax (IHT) up by 3.8%. Overall income received by the Treasury was some £569.3 billion.

Trust reminder

A reminder that reporting trusts must submit data by 31st January 2018 as part of the EU money-laundering regulations. Trustees are now required to maintain specific data about their beneficial owners (i.e. settlors, trustees and beneficiaries) and to update this every year. Full information can be found on www.gov.uk.

Labour tax plans will fail

The Institute for Fiscal Studies (IFS) has analysed the Labour Party's 2017 election manifesto proposals as they relate to tax and has found that raising the upper income tax rate to 50% would not necessarily generate greater tax revenue. To analyse the impact of raising the upper income tax bracket, the IFS examined the tax rises of 2010/2011 as well as other tax increases of recent years. The IFS believes that Labour's prediction that it would generate £4.5 billion in extra tax is unrealistic and that the real figure would be closer to £1 billion.

Editor's Notes

No coincidence

As we go to press the media is full of three different offshore news stories: the Paradise Papers, Transparency International's attack on the UK (accusing it of being a tax haven) and the EU's warning to 53 jurisdictions that they are at risk of being blacklisted for their tax practices. That all three stories should break within hours of each other is obviously not a coincidence. The OECD, EU and other organisations are obviously making a concerted and coordinated attack on what they view as unfair tax competition.

However, it is not as black and white a matter as the politicians and media make out. Either one believes in competition or one does not. If one does, then the logical conclusion is that jurisdictions must be allowed to set their own tax rates and individuals and businesses must be allowed to choose where they locate themselves, their money and their operations.

Thanks to almost 100% transparency and automatic exchange of information, it is no longer easy for those intending to evade tax to do so. But there is a huge difference between evading and avoiding – a difference that governments everywhere seem to have overlooked.

In the next few issues of *Schmidt* we plan to review legal, long-term ways in which individuals and businesses can still make use of tax competition while it lasts. We will also be examining what is likely to happen next. We believe that in the medium to long term new opportunities will arise. History tells us that few international initiatives last for very long before the cracks begin to appear.

The grass *is* greener

If you own or part own and control any business, no matter how small, there has never been a better time to start exporting.
First, sterling has been slowly but steadily declining in value over the last 50 years. In 1967, an American importer would have had to stump up $2.75 to by something costing a pound. Nowadays, they only have to find $1.15. The story is the same for a European customer. In 1999 (the year the euro was launched), €1.40 was required to obtain £1 of goods or services. Today it only takes €1.10.

Second, we are still part of Europe, meaning that the rules and regulations required to export are minimal. Moreover, none of the threatened restrictions on import has been imposed by President Trump in the US.

What about tax considerations? Although international trade taxation is complicated, having an international dimension to your business brings with it all sorts of potential tax benefits. This is particularly true if you don't need to repatriate profits back to the UK. What does the small to medium-sized enterprise have to think about when considering an export drive? Here are a few practical tips:

- Many countries impose a withholding tax on foreign payments. Typically, however, such withholding taxes are only applied if the services (or products) were provided in the foreign jurisdiction itself. It is important, therefore, to make sure that if any element of what you are selling is supplied locally it is separated out on the invoice.
- The UK has an extensive network of tax treaties, many of which allow reduced withholding tax rates to apply between residents of the two territories.
- It is generally possible to obtain relief on tax paid in an overseas jurisdiction. The most advantageous way to claim such relief is through treaty relief or unilateral relief. Either will allow you to reduce your UK corporation tax bill. There can be advantages and disadvantages to creating a permanent establishment in another country. A permanent establishment may simply be the employment of a single worker or can, of course, mean setting up an entire operation. If tax is paid on the permanent establishment then relief will be available in the UK. Normally, this can be carried back for up to three years.
- If is also possible to open up a foreign subsidiary. This can have considerable tax advantages, especially if the subsidiary is in a country with lower tax rates. However, transfer pricing regulations also need to be considered. Happily, small companies do not have to comply with the UK transfer pricing legislation, and medium-sized companies need only apply the rules if HMRC directs them to do so. Transfer pricing regulations generally force group transactions to be priced according to the arm's-length principle, that is the prices that would have arisen between unconnected parties. What HMRC wants to stop is UK companies exporting goods to their own subsidiaries located in zero- or low-taxation jurisdictions, which will then make all the profit and not remit it back to the UK. Incidentally, a small business is much freer to make loans to its overseas subsidiaries.
- Bear in mind that if you are exporting you may also have to visit your customers and potential customers and to explore new markets. This will lead to all sorts of legitimate expenses.

On one hand, exporting is, as I say, complicated and the rules try the patience of a saint. On the other hand, there is an element of 'what happens in Vegas, stays in Vegas' about the whole process. Even a relatively small business can set up a highly tax-efficient international sales operation in such a way as to allow its shareholders to benefit, perfectly legitimately, from all sorts of tax benefits.

Loss cause

Have you been asked to invest money in a start-up business? Has it been suggested that instead of buying shares you lend the business money? Beware! If the business fails to get off the ground – in other words, if it never trades – then you may find you can't obtain relief on your loan. This is because the law states that: "The money lent must be used by the borrower wholly for the purposes of a trade carried on by him." There are all sorts of restrictions regarding what counts as a trade but it doesn't become a qualifying loan unless the business actually starts trading. There are only three situations in which tax relief can be obtained for a bad debt on a loan made by an individual: in a trade that involves the lending of money, under the peer-to-peer lending provisions and where, as I have already said, the money is used by the borrower wholly for the purposes of a trade carried on by him. If lending money to a new business, it is wise to be cautious. Although purchasing shares is not as tax efficient in the short term as a loan if the business takes off (with a loan you can take back everything you have lent before you start paying tax), if things go badly it does have the advantage of giving you the loss relief.

Business property relief tip

Taxation recently carried an enquiry from a reader as to whether business property relief would be available for an artist's studio where that artist's studio was located in a residential house. Basically, the artist in question used every inch of his property to work in or to store works that were for sale. Interestingly, the response by various experts was that 100% business property relief could well be afforded to the whole. This is based on the case of *Seymour 9th Marquis of Hertford* versus *CIR*. Basically the 8th Marquis of Hertford made a potentially exempt transfer of his interest in Ragley Hall, the contents and the good will of the business. He died within seven years of the gift and the transfer became chargeable and less business property relief was due. Although only 78% of the house was open to the public (with all of the exterior being viewable from the outside), it was held that 100% business property relief should be afforded to the whole. The querist was advised to keep evidence that the artist was working on a commercial basis (and that painting wasn't simply a hobby) and also photographic evidence showing what each room was being used for. On this basis there was a high degree of confidence that IHT could be avoided.

Top slicing relief

Taxation also carried an article by Tim Goode entitled 'Calculating Top Slicing Relief' in which he suggested that HMRC is not applying the rules for top slicing relief correctly. In his opinion some taxpayers may be missing out on a substantial amount of relief. This is a complicated area but if you are eligible for top slicing relief you may like to ask your accountant or professional adviser to read the article and see whether you are entitled to an extra claim.

Misuse of power

As reported in a previous issue of *The Schmidt Tax Report*, over the last five years the number of dawn raids carried out by HMRC has increased threefold so that last year some 1,563 raids took place. Over the same period there was also a dramatic increase in the number of prosecutions for tax evasion. For two reasons we can expect the number of dawn raids and prosecutions to increase. First, HMRC is under huge pressure from government to come down hard on tax evasion. Second, since last September HMRC has been the recipient of vast quantities of taxpayer data from around the world. This is as a result of the Common Reporting Standard which basically means that HMRC will automatically receive details of the financial affairs of British citizens no matter where they take place.

If this wasn't grim enough for anyone taking an aggressive approach to their tax planning, the Criminal Finance's Act 2017 gives HMRC the rights to investigate how businesses and their employees may be assisting or encouraging non-compliance by their customers, contractors and suppliers.

There are a number of different statutory offences that HMRC can charge taxpayers (or non-taxpayers), including fraud, false accounting, fraudulent evasion of VAT, false statement for VAT purposes, conduct amounting to an offence, fraudulent evasion of income tax, improper importation of goods, and the common law offence of 'cheating the public revenue.' It must also be pointed out that the punishments for some of these offences are remarkable stringent. For example, someone convicted of cheating the public revenue can face a maximum sentence of life imprisonment.

Before HMRC can raid someone's premises, it must obtain a warrant from a magistrate. Once they are on the premises the only material that HMRC is not entitled to see is that covered by legal professional privilege, in other words any confidential communications between a solicitor and his client in the context of seeking or giving legal advice. There is no legal advice in relation to accountants. During or after the raid HMRC officers have the power of arrest. Bear in mind that HMRC officers are entitled to seize and retain anything for which a search has been authorised. They can remove material, including computer hard drives, if they have reasonable grounds to believe that the material contains items that they are authorised to seize.

So, although the chances of being raided are slim, what should you do if you find yourself the victim of an HMRC dawn raid? Here are some tips:

- Ask for the names of all the HMRC officers in attendance.
- Make sure that you look at the warrant or other authorisation and make a photocopy before they start.
- Ask that they wait away from any public place while you examine the warrant and check that it is actually legally valid.
- Request that the search does not start until you have solicitors on site to oversee what happens.
- Accompany all the HMRC officers while they are on the premises and do not leave them unattended.
- Take notes throughout the search on what they are doing.
- Examine IT systems with solicitors and any IT experts in attendance.
- Consider whether anything that the HMRC officers wish to remove includes documents or communications that would be privileged.

It is unwise to obstruct HMRC officers and you shouldn't destroy, hide or interfere with any material. In general, it is unadvisable to volunteer any information to HMRC or to answer any HMRC questions until there has been a chance for you to consult your legal representative. After the search, incidentally, the HMRC officers should supply you with a copy of any material seized.

Ask The Experts

Q. In your September 2017 issue of *The Schmidt Tax Report* you answer a question about the application of enhanced SDLT applied to a home being bought by a man for his own occupation, who already had an interest in a property that began life as a bank but was converted into two shops with two flats above. What would be the situation if a similar commercial property was owned by a limited company of which he were the majority shareholder? Could it then be said that he already owned a residential property by virtue of him being the owner of the company? In law the company, not him, owns the property and he just owns shares in the company. I have looked at the HMRC website giving advice on the matter and, while they talk a lot about partnerships and trusts, I can see nothing about residential properties owned by limited companies. This situation must occur quite often either as a result of a portfolio of residential properties being owned by a limited company or a flat above a shop or a caretaker's bungalow on an industrial estate.

Perhaps a reply to this question might be of interest to your readers?

C. H., via email

A. The new SDLT rules do not look through the separate legal identity of a company. So a shareholder in a company owning residential property would not be liable to the enhanced SDLT charge when buying his first property if he owned no other properties outside the company.

However, companies themselves are automatically liable to the 3% additional charge on residential properties (unless buying an interest worth less than £40,000) regardless of whether they already own a residential property.

Gone Fishing: Or How To Get HMRC To Back Off

Generally speaking, if there is a theme to the administration of our chaotic tax system in the UK, it is that HMRC is envisaged as being a watchdog, not a bloodhound. In other words, you and I send in our accounts and tax returns: the inspectors just check what they're given, and are at liberty to disagree with us that they are accurate if they happen to come to that conclusion. What the law doesn't seem to encourage is a practice of the taxman nosing around in your affairs on the off-chance that he might find something wrong, or rather, it doesn't encourage this in a completely unlimited way. There is the fairly well-established concept of the 'random' HMRC inquiry. We're not sure how many of these actually are undertaken by HMRC, because in practice it's very rare that a Revenue inquiry is opened without some specific possible cause for concern being identified in the first letter the taxpayer gets. But the important point to note is that self-assessment inquiries can only be opened under a strict timescale, which is broadly the period of one year after the submission of the return.

Rather than setting out the rules in a dry as dust fashion, we think it would be much more interesting to consider a situation that's actually based (loosely) on a real life case we've seen recently in practice. In the extremely unlikely event of the tax inspector concerned seeing these words and realising they're about him, though, we'll make one very important point: the parallel is by no means complete and the facts have been subtly remodelled, although still in a true to life fashion, in order to illustrate the point.

The brown envelope arrives

This is what anyone with remotely sizeable or complex tax affairs dreads. A letter arrives from HMRC stating that they've decided to raise an inquiry into your tax affairs. Sometimes this is an apparently fairly harmless looking communication, quoting the relevant section (usually Section 9A, Taxes Management Act 1970) and saying that the taxman wants to look a bit more closely at certain aspects of the return. In the case we're looking at here, however, it's an awful lot more threatening seeming.

The Revenue doesn't mince its words in its communications, and it seems completely indifferent to the psychological effect of the words it actually does use. In this case, the colour drains from your face as you tear open the brown envelope: it's from a division of the Revenue which has the word 'fraud' prominently printed at the top right-hand corner of the letter. You are invited, in fact, to own up to nameless crimes and given very little indication (in this type of inquiry) as to what precisely HMRC is claiming you've done wrong.

If you'd seen as many of these sorts of openings fizzle out into nothing as we have, you wouldn't be anything like as worried. But, needless to say, you send a copy of the letter to your accountant and follow this up with a phone call in which you bleatingly ask his advice.

The dread invitation

More often than not, the letter will ask for an early meeting between you and your accuser, with your accountant present should you wish. Of course, you do wish to have your accountant there, but you're not at all sure you want to have the meeting, so you ask the accountant's advice.

Professionals differ very much in their approaches to Revenue inquiries of this sort, and there isn't necessarily a right or wrong answer in any given situation. In this case, in an effort to penetrate the mystery of why you've been singled out for this treatment, the accountant agrees to have a meeting with the inspector – but without your being present. On the one hand, in the give and take of face-to-face conversation, the truth behind the Revenue's approach is more likely to come out… or at least be broadly hinted at. On the other hand, if you aren't there yourself as a taxpayer, you can't put your foot in it.

All becomes (slightly) clearer

Following the meeting with Hector, the accountant phones you up. Hector has been quite mysterious still, obviously not wanting to show his cards at this early stage of the game. But he has dropped heavy hints about three areas in which he thinks you might have been a naughty boy:

- He's wondering whether work to your own house has been put through as repairs to the company's premises.
- He's wondering whether all of your travelling on business is really such, or whether you've slipped the odd holiday in.
- He thinks that not all of the company's turnover might have found its way into the company's bank account, being instead banked in some account in your personal name.

The truth

Of course, however polite he is, the accountant doesn't know for certain whether any of these hints is well based. You naturally wouldn't have told him if you were getting up to shenanigans like that. But, as it happens, in this instance you know that you are 100% innocent of any of these types of tax evasion.

That's not necessarily the same as saying you've always been completely whiter than white, of course. A high proportion of individuals, whether in business or not, have an other than completely unblemished past. We've even heard of tax inspectors themselves paying cash to have work done cheaply on their houses! But in this particular scenario, any slight and venial errors you may have committed are all a very long time ago, in fact over 20 years ago.

'COP9'

The accountant explains to you that this is a 'COP9' inquiry. What this means is that, if you decide to take them up on their offer of this type of inquiry, they are offering you immunity from prosecution for any tax evasion or fraud you might actually have committed. In return for this, they obviously want a commitment that you will make full disclosure of anything that may be wrong.

This presents you with a terrible dilemma. In order to get the immunity from prosecution, you need to say, or at least imply, that there is something you want to disclose. The acceptance form requires that. The problem is, in this case you're completely innocent. But if you don't sign the form, there's no way HMRC is going to give you immunity from prosecution – and sometimes there are unjust convictions.

In this instance, though, you manage to use 'weasel words' which imply that you may wish to disclose something, without actually saying so. And the taxman, in this instance, accepts that, because he's already decided that he wants to do this as a COP9 inquiry.

The inspector gets stuck in

Because the accountant has insisted that the taxman's queries should be dealt with in correspondence, rather than being fired at you face to face over an office table, the detailed lists of questions start coming in. You answer all of them to the best of your ability, but you find that, the more information you give him, the more he picks up on to ask questions about.

This process can easily go on for months or even years without any really solid information passing from the accountant or the taxpayer to the Revenue, and in this particular instance it all starts to seem rather futile. Nothing you have told the taxman, and none of your private bank statements, which you've shown him for the last 12 months, reveal any cause for concern. It just so happens that you have recently fallen out with a key member of staff who had access to the accounting records of your company, and you have dismissed her for gross misconduct. The accountant's more than suspicion is that the Revenue inquiry has come about because of malicious information given by this individual. Finally, after nearly three years of putting up with this, the worm turns. The questions asked by the taxman have not just continued to become more detailed but have gone back further and further in time, culminating in a request by the inspector for a summary of your personal wealth going back no less than 15 years, to explain to him how you've come by all of it.

You and the accountant both agree that the time has come to call a halt, in any way you can, to this apparently never-ending fishing expedition on the part of HMRC.

I know my rights

This is where it's essential that you have an accountant or tax adviser who knows exactly what the rules are. It takes us back to what we said at the beginning, about HMRC being given basically a watching brief, rather than the right to nose around in your private affairs without any limit. As always in legal questions, there's the theoretical position as set out in the tax statutes and then there's the real practical rock-bottom reality of the situation.

If you look at the actual rules which are printed in the Taxes Management Act, you'll see that the Revenue's rights are by no means as extensive as inspectors might have you believe.

First, under the self-assessment rules which have applied since 1996, the taxman can open an inquiry into your affairs at any time in the 12 months following the filing date for the return. This means that, as we write (in November 2017), any self-assessment taxpayer can have his tax return for 2015/16 opened up, but not the return for any earlier year – unless the return for that earlier year has been submitted late. So, does this mean that HMRC isn't entitled to ask questions about any earlier year?

Not quite. They are entitled to request (and if not responded to, require) answers under an Information Notice, officially issued for the purpose of checking your tax position. However, unlike the position with an inquiry properly raised for the most recent year, HMRC does actually have to provide some justification for issuing an information notice. So, if one is raised for earlier years, which aren't under inquiry, you have the right to appeal against this notice and ask the taxman to justify his implied belief that your returns for those earlier years may not be correct. This is a strength of the taxpayer's position which HMRC officers are very slow to acknowledge exists. Often a fairly robust approach to the inspector, pinning him down (if necessary, again and again) to specify his reasons for asking for the information, can lead to the inspector backing off.

One very misleading phrase you will often see in letters from the Revenue is the statement that they are opening an inquiry "under the discovery provisions of Section 29, Taxes Management Act 1970". This is complete rubbish. The Revenue has no right to inquire under this section of the Act.

What they have the right to do is to raise an assessment to collect extra tax if they 'discover' that your returns have not shown enough to be due. Discovery means that they have some kind of information, and this is radically different from the proposition which says they have the right to ask for information when there is no prima facie case against you.

How far can they go back?

The normal rule is that an assessment for past years' tax cannot go back more than four years. So, as we write, in November 2017, tax years ending before 5th April 2014 are out of time for a normal assessment to be made. This is one benefit, incidentally, of having been in the EU, because the previous time limit was six years, and four years has been brought in to harmonise with the general rule across Europe – plus to enable HMRC to refuse to make repayments for earlier years, of course.

The four-year time limit is extended to six years if the assessment is to make good tax which you have 'carelessly' failed to self-assess correctly. If you have deliberately misstated your tax, the Revenue has a 20-year time limit.

So what?

So, let's apply these theoretical rules to the practical situation we've set out above. Nothing in the exchanges of question and answer in the wearisome three years of this inquiry has given any rational person reason to believe your tax is understated. You've even come out with the direct statement that you suspect their inquiry is the result of a malicious 'grass'. They're now asking for information going back 15 years. What should your approach be?

It's always a matter of judgement, of course, because no two Revenue investigations are the same. But in the circumstances we've described, we think you should dig your heels in completely and decline to provide information for any periods earlier than the periods assessable under the four-year limit. If you are really confident of your case, you could refuse to provide information for any earlier year than that which HMRC has formally under inquiry. But a more moderate approach may be more likely, in reality, to convince the inspector of the weakness of his position in the event of any of this finding its way to the tribunal. He quite simply isn't entitled to expect you to justify all of the changes of your wealth over a 15-year period, because he's established no prima facie case that you have been getting your tax wrong in any way.

Stand your ground, and we suspect strongly that HMRC will lose the will to live, metaphorically speaking. You can reasonably confidently expect a letter from the taxman making the first tentative overtures towards a closure of this long-running and futile inquiry.

Shades of grey

In our hypothetical example above, we've assumed a fairly straightforward case of an innocent person wrongly accused. Perhaps, though, you are a sinner in tax matters (as we all are in general life). The approach to an ever-widening inquiry will depend on two factors, if we are to face reality:

- How guilty you actually are in respect of earlier years; and
- Whether the taxman has actually uncovered (or you fear may have uncovered) any of your past delinquencies.

If the inspector knows you have overstepped the mark in earlier years for any reason, we would suggest the only prudent way forward would be to make a full disclosure. This is the lesser of two evils, because if you don't set out what you think you owe in terms of arrears of tax yourself, they will come up with some figure which is likely to be very much bigger, based on the worst possible case from your point of view.

If the Revenue hasn't discovered any of your past delinquencies, the message we have to give is much more complex. Morally, and from the point of view of the professional integrity of those in advising you (including ourselves in this article), there is only one possible answer: make a full disclosure. The position is that the Revenue has proven nothing against you and you can in principle adopt the robust, even stroppy, approach we've advocated above for use by the innocent person. This is a matter we are obliged to leave between you and your conscience.

Summary

In summary, however, if you are suffering under the heavy bombardment of HMRC's inquiry artillery, bear in mind the following key points:

- You don't necessarily have to give in to all HMRC's demands for information, because they don't always have the right to ask for it.
- As HMRC has to make a case against you in order to get the maximum tax, there's no reason why you should help them construct this case by volunteering information they aren't entitled to.
- HMRC's ability to go back several years is heavily circumscribed by the legislation.
- The above facts are never going to be made clear to you in any communication from HMRC. Instead, you need to have an adviser who is 100% clued up on the rules, and is not afraid to stand up against any attempt by the taxman to overstep the mark set for him in those rules.

More generally, there's a strong temptation, akin to the hunted animal's irrational wish to surrender to its enemies, to be effusively helpful and cooperative with a hostile HMRC inquiry. Resist this temptation if you don't want to end up paying an unfairly huge tax bill. Paradoxically if you like, the taxman treats those who stand up to him better, in the final analysis, than those who allow him to treat them as a doormat.

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Feature: The Ultimate Form Of Tax Avoidance

I suppose, strictly speaking, death is that. However, we're certainly not suggesting, however depressing you may find it living in today's Britain, that you deliberately take this way out. Traditionally, that road leads to hell, and this might be seen as even worse than being subjected to the attentions of today's HMRC!

No: what we're talking about here is not getting out of life altogether, but getting out of the UK. Moving abroad, and taking some of your family and, as much as possible, livelihood with you, if it isn't the ultimate form of tax planning, could at least perhaps deserve the title of the penultimate form of tax planning. If you're really serious about upping sticks and going somewhere else, this clearly has a radical effect on your taxation affairs – hopefully for the better. So let's have a look at this, very real, option, which all of us sufferers under the UK regime have available – at least in principle.

Becoming non-resident

A naive person might ask: "Where can I look up the rules as to UK residence for tax purposes?" Such a person obviously doesn't understand the patchwork quilt which is our legal and tax system in this country. For 100 years or more there were virtually no written rules as to what makes you resident or non-resident here. Instead, there was a set of decisions in various cases, whose principles might or might not apply in one's own situation.

Then, in 2013, a reasonably clearly expressed set of rules came in. Excellent, you might say. The only drawback is, these rules, while expressed in black and white for the most part (although there are some shades of grey), are immensely complicated.

The best thing you can do, assuming you have Internet connection, is to go onto the website of a large firm of accountants (e.g. KPMG) who have a flowchart designed to help you decide whether you are a resident here, if you are in any doubt on the question.

Rather than trying to summarise all of these rules in the space we have, we'll content ourselves with commenting that the best way of securely establishing non-UK tax residence is 'really' to emigrate: to move your home, family and chattels lock, stock and barrel to some other country. No doubt you can achieve non-UK residence by methods falling short of this radical approach, which also, incidentally, involves limiting carefully the number of days you return to this country. One way of short-circuiting the fairly radical requirement of complete permanent emigration is to go abroad to work full-time. However, if you are looking carefully at the rules and making sure you tick various boxes, this indicates that you are in the marginal area, and could get things wrong if you aren't careful.

It would be good if we could say, simply, that someone who moves abroad is allowed to spend X days back in the UK. Unfortunately, the value of X (which is a variable) depends on all kinds of detailed requirements that you will find on the flowchart we mentioned above. So, whatever the temptation, we have to stand out firmly against an overly simplistic approach here.

International taxation: The rules

The basic framework of tax for people who move from one country to another, or have income or other assets in countries other than those in which they live, is, in contrast, reasonably straightforward and even sensible. With exceptions, if you are a resident in a given country, you are liable to pay tax to the authorities of that country on your worldwide income and gains. If you have income derived from another country, for example from a business or rental property in that other country, you are still taxable in the country where you live: but you may also be taxable in the country where the source of income is located. In these circumstances, there is a set of rules to avoid you paying double taxation on the same income or gains both in your country of residence and the country where the income and gains arise.

All nice and simple in principle. Some countries (of which the UK used to be one) have favourable treatment for people who are resident there but have sources of income or gains in other countries.

We've recently read an article, for example, which suggests that residents of Italy can avoid paying tax on non-Italian income and gains. No doubt all of this needs to be checked very carefully with a local adviser, but the basic principle as far as UK tax (which is what this magazine is about) is concerned could be expressed as follows.

If you become non-UK resident, you no longer have to pay tax on any income or gains other than those arising in the UK. As the UK is a highly taxed jurisdiction and probably doesn't deserve the title of 'tax haven', this has, generally speaking, to be a Good Thing.

Tax is a minefield, though. We sometimes form the view that the nearest job to that of a tax adviser is bomb disposal expert. It's very easy to get things wrong, and so here's a list of what are probably the seven most important points to note when moving out of the UK to save tax:

1. Make sure you're absolutely clear as to what the tax rules are in the country you're moving to (unless you're one of those very rare individuals who manage to keep up a completely nomadic existence, not establishing residence in any country). Some countries, such as Italy, could well provide you with a very benign regime if you hold your sources of income outside that country. On the other hand, there are other, more predatory, tax jurisdictions (like the US?) where you are truly jumping out of the UK frying pan and into the foreign fire.

2. Bear in mind that, under new rules which have very recently been brought in, investments in UK residential property are still chargeable to CGT and IHT even after you've left the UK. Other types of UK assets, however, like shares and commercial property, are not chargeable to CGT if you are non-resident, and can also be taken out of the IHT net if you hold them through an offshore 'envelope'.

3. Bear in mind that IHT (which could be, at 40% of your whole estate, the biggest tax bill you ever pay) still applies to your worldwide estate if you are domiciled in the UK. This is a different test from that of residence, and domicile is much harder to change from your UK domicile of origin (assuming that is your original domicile) than residence. It involves a very clear intention to make some other country your permanent home – so the nomads may not get away with an IHT-free estate, for example. If you do manage to change your UK domicile, though, you can basically put two fingers up to the Capital Taxes Office in the UK (which collects IHT) by moving all of your wealth out of the UK, or holding UK assets other than residential property, but through an offshore-based 'envelope'.

4. As well as residential property, there is another exception to the general rule that non-UK residents don't pay UK CGT. This is where an asset situated in this country is used for the purposes of a trade carried on through a branch or agency here. Actually, this rule can be avoided quite easily, by holding the UK-based trading asset in a different entity, as far as immediate ownership is concerned, from the entity which carries on the trade.

5. If you go abroad and realise a substantial capital gain, or take a substantial income payment (such as a dividend from your own company), remember that this is only tax-free providing you stay out of the UK for at least five years. If you return before five years have elapsed, the amount concerned becomes taxable in the year of your return. So periods abroad of five years or more are clearly very advisable if you have any such intentions.

6. Even if you are not intending to emigrate from the UK at present, be very careful about putting investment assets, like buy-to-let properties for example, into UK companies. While assets other than residential properties and trading assets (see above) are outside the scope of UK CGT if you emigrate, acquiring them in the ownership of a company effectively means you can never emigrate – as far as the ownership of these assets is concerned. Whatever happens, the UK-incorporated company will always be treated as resident here for UK tax purposes, even if you move abroad and manage and control the company from abroad. So, by putting such assets into a UK company, you have effectively trapped gains on those assets in the UK tax net forever. This doesn't matter, now, of course, where the asset concerned is a UK residential property, because these are now within the scope of UK tax even if owned by non-residents. However, it could be very much a case of shooting yourself in the foot if you put other sorts of investment assets in a UK company.

7. Unlike companies which are incorporated in England and Wales, Scotland or Northern Ireland, non-UK-incorporated companies will not invariably be treated as UK resident. As far as UK tax is concerned, such offshore incorporated companies will be treated as resident, for tax purposes, wherever they are managed and controlled.
But there's a trap here too. If you have an investment property portfolio of any kind owned in a non-UK-incorporated company, but you are yourself UK resident, you can accidentally bring about the position that the company itself emigrates when you personally emigrate. Why is this important? The reason is because, while an individual who holds investment assets can become non-UK resident, without any tax implications, a limited company which emigrates is treated by the rules as having disposed of all of its capital assets at their market value on the date of emigration. This applies whether the assets are UK sited or not.

Be very wary, here, of situations where offshore company agents claim their arrangement ensures that their companies are resident outside the UK. It's certainly not beyond the taxman to argue that, if you are the dominant influence in running the company, and you are based in the UK, the company is therefore itself UK resident as well. By the same token, when you emigrate, they can argue that the company has emigrated too: with the result that you have this 'dry' tax charge on a 'pretend' disposal of the company's assets.

So, a lot to think about there, potentially. If you take away from reading this article nothing but the principle that you need to look carefully at your whole asset position before becoming non-UK resident, we will probably have succeeded in our main aim. But all these points don't take away anything from the main idea and advantage of emigrating from the UK: which is that you move from being chargeable at UK rates of tax on your whole worldwide income and gains to being taxable only on UK income and one or two specific types of UK gains. Finally, if you manage to lose UK domicile, you can also wave goodbye to IHT, which could be the biggest tax-saving action you ever take.

The Enterprise Investment Scheme At A Glance

As government-sponsored tax avoidance, the EIS deserves more than a passing look from those who want to reduce their tax liabilities in a non-confrontational fashion. So we thought it would be useful to give a thumbnail sketch of the way the scheme works, and this is probably most clearly done in a question and answer format.

1. What is EIS?

The Enterprise Investment Scheme, or EIS, is a way of encouraging taxpayers to invest in limited companies carrying on business in the UK. Any company can qualify in principle, providing it meets the various criteria, and there is no need to set up a special type of company. The way taxpayers are encouraged to invest in newly issued shares in such a company is by giving various, fairly generous, tax reliefs to those who do so invest. As we say, any company can apply to be given EIS status, and there's no need for it to be a special type of company or even for the company to have been set up originally with EIS in mind.

2. How does a company qualify?

A company, or more specifically the issue of the shares in a company, qualifies for EIS relief if the money is raised for the company to carry on a 'qualifying trade'. You will find a list of what the qualifying trades are in the HMRC booklet on the subject, or on the Revenue's website, but to sum up these are basically any trade except for a list of excluded activities that are mainly those which involve substantial investment in land (like farming, hotels, nursing homes, property development, etc., etc.) or what might be termed the less 'worthwhile' financial activities, like trading in shares or providing financial, accountancy or legal advice. Research and development qualifies for EIS even if the company doesn't begin trading immediately following the issue of the shares.

3. What reliefs are available?

Potentially there are three very valuable reliefs. In order of general importance for most investors:

- The investor gets relief of 30% of the investment against his income tax for the year. This can be income tax basically of any kind, and there isn't a restriction to earned income as there is, for example, with pension contributions. An investment in the issue of shares in an EIS company which qualifies for the relief is effectively treated as if it were a payment of tax to HMRC of 30% of that amount (see below for Seed Enterprise Investment Scheme (SEIS) issues.
- If the shares are held for at least three years, any sale of those shares for a capital gain achieves complete exemption from CGT; not such an immediate tax saving, but potentially it can dwarf the income tax saving by tens or hundreds of times, and so shouldn't be overlooked.
- If you have made capital gains, the gain can be matched against the EIS investment and tax deferred.

4. Is there a limit on how much of the company you can own?

For the first two of the above reliefs, which are the income tax relief on subscription and the exemption from CGT on sale after three years, you have to ensure that you, together with certain types of associated person, don't control more than 30% of the company. The CGT deferral relief, on the other hand, is available no matter what percentage of the company's shares you own – even 100%.

5. What can go wrong?

Inevitably, the EIS being a scheme to encourage enterprise and small company start-ups, there has got to be a risk of the whole investment going wrong. If you lose some or all of the value of your shares, however, and actually crystallise a loss for CGT purposes, you do have the possibility of a 'consolation prize' in the form of a claim to offset the loss (less the income tax relief you have already had) against your total income for the current or previous year.

Another thing that can go wrong is that you can end up losing, or not being granted, relief on your investment if there are any technical defects in the arrangements. For example, those who are already employees or directors of the company, or who have started off with too high a percentage of the share capital, can be denied relief because they have breached the technical criteria. An investor in an EIS company can become a director, but generally speaking you should make sure that you don't become a director until after you've invested – and even then, you need to be very careful not to take remuneration from the company which is excessive in HMRC's opinion.

There are some quite obscure ways in which relief initially given can be clawed back by HMRC. One such is if you, or a connected person, 'receive value' from the company, and this can be nothing to do with your tax planning if it is a connected person. Or relief can be clawed back if it turns out that the company doesn't use the money raised for the purposes of a qualifying trade within the necessary period of two years. The problem is that these occasions of clawback may not be under your control as a minority investor in the company.

6. How does SEIS differ?

The SEIS is a younger brother of the basic Enterprise Investment Scheme (or EIS). Ruthlessly summarised, the differences are that (a) SEIS gives you 50% income tax relief rather than 30% and (b) it is only available at the outset of the business, and only for very small amounts of money raised (comparatively speaking).

7. What are the practicalities?

Where it's recognised from the outset that EIS relief is important, it's customary for those promoting the company to approach HMRC for an informal opinion to the effect that EIS relief will be given. Whether or not this is done, EIS relief is first of all specifically claimed immediately following the issue of the shares in question (not all shares issued by a company need to be claimed for EIS relief). This is done by filing in form *EIS 1*, giving details of the company and reasons why you think it qualifies to HMRC. Inspectors may then come back with queries, but subject to these, if they decide that the company does qualify for the scheme, they will issue the company with an *EIS 2* form. The company then issues certificates, logically labelled *EIS 3*, to the various investors confirming that they can claim the relief in their tax returns.

It's actually, comparatively speaking, fairly unbureaucratic: a refreshing change from so many tax reliefs. So, don't be afraid of claiming EIS relief for a company you are involved in by fears of paperwork and red tape. If the relief is there, HMRC make it surprisingly easy to claim it.

Correspondence

We've received the following communication from a reader, which raises a very important and valid point about the way HMRC has treated those involved with employee benefit trusts (EBTs):

"I am involved at arms-length with an EBT. This one was set up in early 2008 because the 75% owner of a successful trading company had acquired a property investment within the trading company which grew to an extent which put BPR into question. He is not young or in good health. His death coupled with the potential IHT would have necessitated sale of the family company (his children are involved). Happily, he is still alive.

"The EBT was set up to distance the investment from the company without devastating immediate tax consequences arising from the exercise. The owner is meticulous about tax and ensured that everything was carried out totally compliant with the then known tax law, under the very expensive advice of one is the well-known tax scheme companies and advised by two top tax barristers. The Trust is offshore and so the income from the property investment bears tax @ 45% (rather than normal Corp Tax rates) – accepted as part of the price of procuring the benefits.

"A large loan was drawn down by the owner in late 2008 from the EBT for the purpose of a personal outside investment (not part of any ongoing contractual remuneration arrangement). He was not an employee or a director. Unhappily the outside investment has been a failure.

"All the advice, until recently, has been that the loan was not taxable – no queries have been raised by the Revenue at any time. It is now over eight years since the loan was drawn down.

"Now that there is notice from HM government that the disguised remuneration rules are to be back dated, it appears that the company – and, perhaps, himself –will be exposed to total PAYE and NIC on the drawdown of the loan.

"What I do not understand (having been a practising lawyer who has proceeded under the impression that retrospective legislation on tax was not part of our system) is why there is not a great outcry from tax lawyers/accountants/advisers/newsletters about this proposed extraordinarily wide, carpet bombing, deeply retrospective disguised remuneration legislation. I see none – even from The Schmidt Tax Report. I do follow that many EBTs were blatantly part of a remuneration scheme and that politically it is difficult to take issue with the steps being taken. Not all of them, however, were. Where now for tax planning of any kind?"

[Reader's Name] via email

We agree. Whitehall (or, to be more precise, Somerset House) has overstepped the mark in its response to the massive tax-avoidance industry involving EBTs. The idea was first heavily marketed in the last years of the twentieth century, and continued despite fairly virulent anti-avoidance legislation in 2002. The promoters, who were cock-a-hoop at their own cleverness, came up with devious ways of getting round the anti-avoidance legislation in 2002, and they seem to have thought that they were invincible. In real life, unfortunately, Goliath usually flattens David with one stamp of his enormous foot.

Having announced some years ago now that EBTs were one of its 'principal tax avoidance targets', HMRC has gone on to impose wave after wave of punitive new legislation.

But let's just set out, for those who are new to the EBT game, how the tax planning was meant to work.

The basic idea was simple. If a company was anticipating substantial profits, it would set up an EBT, which may have been notionally for the benefit of all of the staff of the business but was usually actually just set up for the benefit of the main director/shareholder. A contribution was made into the trust by the company, and the cash was then loaned to the individual concerned. The idea was that, being a payment for the purpose of remunerating its director(s), the payment to the EBT was allowable against corporation tax and reduced the company's profits to some negligible sum. The trust itself was not taxable on the receipt of the contribution, because it was holding it for the benefit of the 'employees' (in reality the main director), and therefore the trust itself had not got any richer.

No tax

Moving on to the loan stage, as a loan it didn't fall to be treated as income of the individual concerned – because, in principle at least, he was due to pay it back to the EBT. Even the threat of a charge to tax under the 'beneficial loan' provisions (because the loan is by reason of the director's office or employment) could be eliminated by providing that the director should pay a commercial rate of interest on his loan. In almost all cases this interest wasn't actually paid but simply rolled up to increase the loan balance, so that the individual didn't even have to put his hand in his pocket.

The anti-avoidance legislation in 2002 was designed to eliminate this sort of planning, as its promoters hopefully believed. It introduced a rule to the effect that, where there was a payment to an EBT, it wouldn't get tax relief in the company's hands until such time as the individual concerned had paid tax on the receipt of a benefit, paid out of the trust to him.

The loophole hunters gleefully exploited these rules by taking the contributions to the EBT out of the realm of description as a 'payment'. For example, a life insurance policy might be taken out by the company, and its rights over that policy were surrendered in favour of the EBT. So, the argument ran, this wasn't a 'payment' to the EBT and therefore the rule which said you couldn't get relief for such a payment didn't apply. Perhaps you get the idea of the type of ingenuity being applied to this sort of avoidance.

The public impression given by reported cases is that all such attempts to produce 'son of EBT' and 'grandson of EBT' and so on have actually been unsuccessful. The tribunals and the courts just don't like tax avoidance and will decide for the Revenue if they possibly can. This may not be a true picture of the reality of the situation, because cases where the Revenue has backed down tend not to reach the public domain at all. Nevertheless, there's no mistaking HMRC's truly vicious response to companies which deal with EBTs in any way.

'Full fat' and 'skinny' schemes

It was thought, not so long ago, that you could get some of the benefits of EBTs without their disadvantages by refraining from claiming a corporation tax deduction for the contribution, and hence being non-aggressive. Why would you make a contribution to an EBT if the company didn't get tax relief?

Well, one reason would be to ring-fence the money concerned from any commercial risk afflicting the company. Once the payment is in the EBT, it no longer belongs to the company and is no longer available, in principle, to the creditors of the company if anything goers wrong financially with the company's business. The payment can be made in such a way that the money is held in an IHT-efficient arrangement.

Somewhat to the surprise of the promoters of these 'skinny' schemes, HMRC's attitude to them seems to have been just as vindictive as to those schemes where corporation tax relief is being claimed. HMRC has even gone to the length of imposing swingeing PAYE and NI assessments on the amounts loaned. And, to cap it all, as our correspondent has said, they have now introduced rules to say that any such loans still outstanding at 5th April 2019 will be taxed under PAYE anyway. (This perhaps puts a question mark on the validity of their assessments to PAYE on the loans which they have already made – but who cares about consistency when it's a question of crushing rebellious taxpayers under the iron heel of the Executive?)

Carpet-bombing

In our view our correspondent is quite right to refer to the Revenue's approach here as carpet-bombing. The Revenue is basically lashing out in a completely indiscriminate fashion against anybody who has used EBTs regardless of whether there was any tax-avoidance motive involved. It's arguable whether imposing a tax on loans which are still outstanding on 5th April 2019 is retrospective taxation, but there is certainly a case to be made out that it is so.

As always in these situations, the powerful will get away with murder unless there is sufficient protest. We would therefore suggest our readers do indeed write to their MPs, providing they feel strongly enough about this issue, to point out that the government is trampling on the rights of its innocent citizens here, in order to satisfy a kind of vindictive monomania aimed against EBTs on the part of what might be one or two individuals within Somerset House. A good example of allowing unelected bureaucrats to lord it over us in what many would see as a completely tyrannical fashion.

The moral

A more general moral to be drawn from this unhappy story is to avoid the more artificial, contrived and aggressive type of tax-avoidance structure unless you want to take on Mr Goliath at the Tax Office. Ever since serious, industrial levels of tax avoidance were first entered into, in the 1970s, there has been a view that, in the worst case, all HMRC can do is put you back in the position you would have been in if you hadn't undertaken the planning. It now looks as though inspectors are out for blood, and people will end up, in many cases, in a much worse position than if they simply had paid their tax in the first place. Be warned!

A Brief Guide To Protection: Part 2: Using Life Assurance To Protect Your Estate

In last month's article I looked at the various types of protection policies which exist to provide financial security in the event of death or long-term illness. This month I am looking at how life policies written under a suitable trust can be used to ensure that death benefits are paid out without creating a tax liability and provide protection for the value of your estate on death.

Using trusts

In order to ensure the prompt payment of benefits, and also to avoid IHT, it is usually advisable to assign life assurance policies to a flexible trust. Draft wordings are commonly available from insurance companies at no extra cost but it is advisable to seek legal advice to ensure that the wording is appropriate for your particular circumstances.

Once the death benefit is paid to the trust, as the trustees will hold the benefit subject to a discretionary trust, the normal IHT rules which apply to the taxation of discretionary trusts (the 'relevant property' regime) will also apply here. This will mean potential periodic and exit tax charges.

Periodic charge

The periodic charge may arise on each 10-year anniversary of the creation of the trust. The maximum rate of tax that can be charged is currently 6% of the assets over the available nil rate band. The periodic charge is based on the value of the property in the trust, which is referred to as 'relevant property'.

In the case of an insurance policy, the value of the relevant property is the 'open market value' of the policy. The market value of a life assurance policy used for IHT purposes is usually negligible if the life assured is in good health, so a periodic charge is not usually payable during lifetime. However, while one may become due if money is held in the trust after a successful claim, in most cases the policy proceeds should leave the trust before this happens.

Exit charge

An IHT liability may arise where capital leaves the trust, such as when the trustees pay the policy proceeds to a beneficiary following a claim. Different calculations apply depending on whether the distribution occurs before or after the first 10-year anniversary of the trust.

Where an exit occurs during the first 10 years, the calculation is based on the value at the date when the trust was created. Where it occurs between 10-year anniversaries, it is based on the amount paid at the last periodic charge. In either case, if the life assured had been in good health at that time there would not usually have been a charge, so an exit charge should not apply.

Insuring against IHT

If you have an IHT liability which you are unable or unwilling to take measures to reduce or avoid, or where you have already done as much planning as is practical or with which you are comfortable but are concerned about the loss of your family's wealth to the Exchequer, you may want to consider the role of life insurance.

Sometimes it is a better use of the family's resources to purchase life insurance cover equal to some or all of the remaining IHT liability. While paying for insurance is in effect the same thing as paying some of the IHT in advance, it does have the benefit, for those in reasonable health, of being simple and allowing you to retain maximum flexibility and control over your wealth.

A joint whole-of-life policy (with payment made on the second death, which is when the tax liability would arise) is usually the most competitive type of policy for couples, but single people might find a term policy better value. In any case the cost of the insurance is likely to be much less than the tax liability, and in some cases a lot less. Insurance is not a panacea for IHT, but as one of a range of possible solutions it is worth considering.

If you have made an outright gift for which you need to survive seven years before it becomes excluded from the value of your estate (a potentially exempt transfer, or PET), you may be concerned about the IHT liability that might arise should you not do so. In this scenario a short-term life policy may be affected, with the cover equal to the tax liability.

Depending on the particular circumstances, cover may need to be on a level or decreasing basis to match the liability, the latter being known as gift *inter vivos* ('in life') cover.

It is particularly important for any cover intended to protect against an IHT liability to be written subject to a trust to ensure that the benefit would remain outside your estate and be available to your beneficiaries. The proceeds of policies not written in trust merely fall into the estate, exacerbating the IHT problem and being unavailable to the beneficiaries until the estate has been distributed.

Relevant life policies

One final type of policy which may be worth considering for life insurance protection is a relevant life policy (RLP). This is a life policy that is taken out by a company, limited-liability partnership (LLP) or sole trader for the benefit of an employee. Subject to certain conditions, the premiums will be deductible against corporation tax (or profits in the case of a sole trader or members of a partnership) and not assessed as a benefit in kind for income tax and NI purposes against the employee.

Partners, LLP members and sole traders are not employees for the purposes of an RLP, although a director of a limited company is treated as one, whether or not they take substantial remuneration. This opens up the possibility of directors arranging their personal life insurance through their own business and, as a result, lowering the net cost substantially compared with a personal policy.

The company, as the employer, would apply for the RLP and as part of the application process would also complete RLP trust documentation.

The company would therefore be a trustee of the RLP, but it is perfectly acceptable to appoint additional individual trustees such as the insured's spouse. The RLP benefit would be payable on death before age 75. Most providers interpret the RLP legislation as allowing for life cover only, although one provider's interpretation has enabled it to offer combined life and critical illness cover.

In the event of the insured's death, the insurer pays the sum assured to the trustees of the RLP. The trustees would have discretion as to who should receive the benefit from the classes of beneficiaries specified in the trust. If the insured has previously completed a nomination form addressed to the trustees of the RLP trust, this gives a non-binding expression of their wishes as to whom they would prefer to receive the death benefits, in a similar way to the method of nominating beneficiaries under a registered pension scheme.

There is no statutory maximum amount that may be provided by an RLP. Insurers may have their own commercial maxima and associated underwriting/financial underwriting limits and the sum assured should be reasonable in relation to the employee's circumstances in order to secure tax deductibility for premiums paid by the employer under the 'wholly and exclusively' rules on the provision of benefits under the plan.

There are no other tax implications as long as the life assured is alive.

If the life assured leaves service and takes up a new employment, it may be that the new employer will be prepared to take over payment of the premiums and so keep the cover in force. Alternatively, premium payment can be taken over by the life assured, who would then pay the premiums from their own net income. In this instance, the policy will remain in trust for the benefit of the named beneficiaries, although the previous employer might need to be retired as trustee and a replacement trustee appointed.

For those who qualify as an employee and need life insurance protection, a relevant life policy is likely to be the most cost- and tax-efficient way of providing cover.

Summary

When it comes to thinking about your financial security, there are two main assets you will seek to protect. The first of these is your human capital – for most families with one or more working adults, the loss of the value of their future income stream is the highest risk the family bears until such time as financial capital has built to a level whereby the family would be financially secure without the earned income stream.

If you have a health condition or there are other potential adverse factors, or you are applying for a relatively high level of cover (£500,000+), it is probably worth making multiple simultaneous applications (any medical examination required can usually be carried out once and the results shared between insurers) to see which provider offers the best terms.

The second asset is the value of your estate. We each have our own opinion about IHT. Some of us may not have close family to leave our estate to, in which case protecting the value of it may not be of high priority (especially if the plan is to leave your estate to charity, in which case it will not suffer IHT anyway). Others may wish to pass on as much of their estate as possible to future generations, and for those individuals life assurance may be a cost-effective way of achieving that.

Whatever your particular circumstances, ensuring that you have adequate protection in place to meet the individual needs of you and your family is of paramount importance – and should certainly be considered ahead of saving surplus income.

A lifetime cash flow forecast can determine the level of cover required in the event of death or serious illness, and creating one would be a good place to start. You can download software to enable you to do so, free of charge, at our website: https://www.bloomsburywealth.co.uk/voyant-software/.

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Offshore News

Holding company update

In previous issues of *The Schmidt Tax Report* we have highlighted the considerable benefits of forming holding companies in the United States of America. In particular, low-tax states such as Wyoming, Nevada and Delaware offer the option for non-resident aliens (i.e. non-US citizens who reside outside of the US) to form either LLCs or C corporations for the purposes of holding non-US assets with zero tax liability and minimal cost. Wyoming, in particular, has become known as the new Switzerland as it has also enacted highly innovative trust legislation designed to protect assets and confidentiality.

There is, however, a small catch.

Previously when non-alien residents owned 25% or more of an LLC or C corporation absolute confidentiality could be promised.

Now, however, the US Internal Revenue Service (the IRS) has issued a new set of rules. These are relevant to certain foreign-owned domestic disregarded entities. The term 'disregarded' means US entities that are disregarded for US federal income tax purposes. From now on the IRS insists that 25% foreign-owned domestic corporations report identified related party transactions on *Form 5472* (the filing of which would require such entities to obtain an employer identification number from the federal government) and to comply with related record maintenance requirements.

In plain English, ownership details must now be provided to the IRS. Moreover, the LLC or C corporation must maintain adequate books and records of transactions to track any payments or transfers of money, property or other reportable transactions between the disregarded entity and its sole member, whether such transactions are direct or indirect. These records must be available for inspection by the IRS on demand.

What this means is that, while America remains an excellent location for a tax-efficient holding company, unless certain steps are taken the ownership of that LLC or C Corporation will no longer be anonymous and the IRS will have access to information about any of its transactions.

In practical terms, this probably makes very little difference. Secrecy surrounding official ownership for any sort of offshore structure has become nigh on impossible in recent years. Accountants and lawyers in some of the most popular states claim that there are all sorts of loopholes in the new legislation that will allow them to protect the identity of their clients and keep information from falling into the hands of the IRS without breaking the law.

Another Estonian victory

All right – hey hey…
Well, are you ready? – You bet
But are you ready? – Oh yeah
All right – You give it to them now.

It is sixteen years since Tanel Padar and Dave Benton won the Eurovision Song Contest on behalf of Estonia with that hit, *Everybody*, which included the memorable line: "Come on, everybody, cause here is a chance", and one feels that this is the Estonian equivalent to what the Chancellor of the Exchequer must have been humming to him- (or her-) self as he (or she) was redesigning the country's corporate tax system… although, to be strictly accurate, there isn't much of a corporate tax system in Estonia to redesign. Corporate income tax in Estonia is only applicable if profits are distributed, for example in the case of dividends. In other words, while income is retained within a business structure there is no corporation tax. One expert summarised the benefits of Estonia as the location of a holding or trading company as follows:

- for trading – no corporate income tax, until profit distribution;
- for holding – full participation exemption on qualified dividend income;
- no holding taxes on outbound dividends and interest;
- no withholding tax on royalties (if EU and 25% shareholding);
- Estonia is a full member of the EU and OECD, the euro has been the currency since 2011 and it complies with all EU directives;
- shelf companies are available for immediate use; tax resident certificates are available for all Estonian companies within two days;
- very advanced banking system with Internet banking facilities in English;
- there are no thin capitalisation rules in Estonia;
- excellent tax deferral and planning opportunities.

The fact that there is no corporation tax allows individuals and corporations based elsewhere to defer tax on an indefinite basis. This means that retained trading income can be lent out, invested or held with no liability. When distribution takes place (i.e. a dividend is paid), a flat corporate tax rate of 20% is charged.

Incidentally, there are also benefits to living in Estonia. The income and CGT is also flat and also 20%. Moreover, qualified foreign dividend income is tax exempt in the hands of the Estonian tax resident individual. And there is no IHT, no wealth tax and no net worth tax in Estonia.

This year, Estonia introduced something called a limited partnership fund (LPF), which also offers considerable tax benefits. Basically such a vehicle is not considered a taxpayer or an Estonian resident for the purposes of Estonian tax laws and the income earned by an LPF is immediately allocated to its investors in proportion to their equity stakes. Only earnings from Estonian investments are taxed when distributions are made.

As with American disregarded entities, an Estonian LPF will have to submit annual declarations to the tax authority regarding the income earned, the investors of the LPF, the share of the LPF's income allocated to each investor and the tax residence of each investor. Estonian LPFs need at least one general partner and one limited partner, governed by a limited partnership agreement. Interestingly, the LPF does not have to publish the identity of its limited partners or the amount of the investments made by each limited partner.

When searching for an attractive location for an international business, many people may overlook Estonia. However, it clearly offers all sorts of benefits.

To quote Dave Benton and Tanel Padar, "All right – you give it to them now, come on, everybody, let's feel the spark."

La dolce vita

As the Italians say *il denaro apre tutte le porte*, in plain English: money talks. In an attempt to attract *facoltosi danarosi* (the rich) and others who are *nuotare nell'oro* (literally: swimming in gold), the Italian government has launched an extremely favourable tax regime for two classes of taxpayer: high-net-worth individuals and highly skilled workers. We have covered the former in previous issues of *The Schmidt Tax Report* but we thought it would be worth just summarising the benefits the new Italian income tax code offers as it is now one of the most competitive and favourable regimes in Europe.

The key features offered are:

- a flat rate tax on non-Italian income;
- no remittance rule applies – so non-Italian income can be remitted freely;
- no inheritance or gift tax on non-Italian assets;
- no obligation to disclose non-Italian assets to the Italian tax authority;
- exemption from payment of wealth taxes on non-Italian assets;
- inclusion of spouses.

The Italian tax system offers two other advantages: no liability to CGT on residential property providing you keep it for at least five years and no CGT on anything collectible.

For a high-net-worth individual to take advantage of these rules he or she will pay an annual lump sum flat tax of €100,000. There are, however, rules in place to stop the short-term transfer of residence simply to realise a substantial tax-free gain. Non-EU nationals, incidentally, will also benefit from a fast-track procedure for obtaining entry visas and stay permits for Italy.

What if you are a highly skilled worker? Providing you stay in Italy for at least two years, you will receive a 50% income exemption. This applies for five years and effectively means you would pay between 11.5% and a top rate of 21.5%.

In order to benefit from this you must spend at least 183 days of the tax year in Italy and you must have an employment contract held with an Italian company or foreign company that is in the same group as an Italian company. This rule does not, though, apply to self-employed persons. For anyone looking for a low-tax jurisdiction in which to reside, Italy must now be on their list of potential locations.

Secrets revealed

Older readers may remember an advertisement that appeared in *The Times* during the 1980s and 1990s with the dramatic headline: "Secrets Revealed: How to legally obtain a second foreign passport". The advertisement was published by a company called Scope International, which published a series of books with such titles as *PT: A coherent plan for a stress free, healthy and prosperous life without government interference, taxes or coercion*. These books promoted two different concepts. The first was that of the perpetual traveller, or PT (which also stood for permanent tourist and prior taxpayer), and promoted the idea that by basing different aspects of one's life in different countries and not spending too long in any one place, a person could reduce taxes, avoid civic duties and increase their personal freedom. The concept requires individuals to live in such a way that they are not considered a legal resident of any of the countries in which they spend time or operate. By lacking a legal permanent residence status, the theory goes, they may avoid the legal obligations which accompany residency, such as income and asset taxes, social security contributions, jury duty and military service. It has been described as a 'late capitalist nomadism'.

The PT idea was devised by an investment pundit called Harry D. Schultz, who was born in 1923 and may, or may not, still be alive. He was certainly still going strong in 2011, when he published the last issue of his international *Harry Schultz Letter*. He was a legendary character in the investment letter industry: a hard-driving promoter who specialised in bold, radical high concept strategies.

Interestingly, his investment tips were always excellent. For example, in 2011 had you bought every single one of his recommendations you would have seen a gain of nearly 40% compared to S&P growth that year of 17%. His long-term return was a remarkable 8.94%.

Anyway, Harry Schultz came up with something called the flag theory, wherein each flag represents one of the legal jurisdictions under which the PT operates. Initially he suggested that there should be three flags and later he expanded it to five flags:

1. Passport and citizenship – in a country that does not tax money earned outside the country or control actions.
2. Legal residence – in a tax haven.
3. Business space – where one earns one's money, ideally somewhere with low corporate rates.
4. Asset haven – where one keeps one's money, ideally somewhere with low taxation on savings income and capital gains.
5. Playgrounds – where one spends one's money, ideally somewhere with low consumption tax and VAT.

Interestingly, in 1995, the well-known financial commentator Bob Beckman remarked about his residence in Monaco: "A long time ago, I was told that the most efficient way for an individual to handle his affairs was to work one place, keep his money in a second place and live in a third place. I live in Monaco. I don't work here, my money is placed elsewhere, but managed from here."

Is it still feasible in this day and age to live a PT's lifestyle? The answer is yes. For example, you could keep your British passport, take up residence in Ireland, Malta or Estonia (where they only tax income remitted there), run your business from, say, Cyprus or the British Virgin Islands, keep your money in the Channel Islands and spend it almost anywhere you fancy.

Interestingly, the information age has sprung forth an entire generation of smart, capable entrepreneurs who don't rely on a job in one place to make money. Now, probably more than ever before, it may also be sensible to hold a second passport. We live, after all, in complicated and often troubled political times.

The Future Of Exchange Traded Funds

Ten years ago exchange traded funds (ETFs) counted for some $800 billion worth of investment worldwide. This year they account for some $4.2 trillion worth of investment. The reason they are so popular is easy to understand: ETFs can be used to track almost any market you care to name. In particular, they allow investors to track the major stock markets, which over the long term more or less guarantees a return of between 7 and 9% a year. Moreover, this can be achieved at negligible cost. The vanguard S&P 500 ETF, for example, will cost its investors a mere 0.03% in fees and has shown a 20-year return of 6.9%. When one considers that most passive investment managers charge around 1–2% and that even direct purchase of shares can be considerably more expensive, ETFs represent a very low-cost way to hold assets.

Perhaps it is no coincidence that the stratospheric growth of ETFs has coincided with a relatively long bull market run. Many now feel that we are due a market correction. This means, for the first time in history, ETFs are really going to be put to the test.

So what could go wrong?

To begin with, it must be pointed out that the rise of passive management may be inflating asset prices. The huge amount of money being put into index tracking products has almost certainly encouraged a momentum effect. Whereas active managers may buy or sell equities based on fundamental practice such as value, much passive money is effectively blind in that it buys assets according to the rules of the index or theme.

If this is true, it means that money that was previously and actively managed in equity funds and is now in ETFs may well be propping up the largest, most liquid stocks. In plain English, the largest stocks are attracting money purely on account of their size, which, in turn, raises fears of a bubble.

This fear is dismissed by ETF fans. They point out that passively invested funds in general still account for a tiny slice of the market. Some 12% in America, and 7% elsewhere in the world.

Another issue is whether ETFs may pose a risk for new investors. For example, in the UK the historic price to earnings ratios of the UK's FTSE all share index sits at above 20, at which point past experience tells investors to be conscious of the downside. Will ETFs be more volatile when the inevitable stock market correction occurs? They certainly played a role in the flash crashes of May 2010 and August 2015. Indeed, the US Securities and Exchange Commission (SEC) says that ETFs, "experienced more substantial increases in volume and more severe volatility than standard stocks". Moreover, the SEC felt that the extreme swings in price seem to occur idiosyncratically among otherwise seemingly similar ETFs.

The reality is that ETFs are here to stay and, if one follows a sensible policy when choosing the ETFs one invests in, there probably isn't a more secure way of earning a competitive long-term return.

At *Schmidt* we would probably recommend avoiding so-called synthetic ETFs that bear the risk of failure of the counterparty, such as an investment bank, on the other side of the investment swap from the fund manager. It is probably much safer to only buy ETFs that invest in actual stocks and shares. In other words, they must buy and sell the different investments that make up the indices and not simply aim to track with the use of swaps and insurance policies.

The Only Way Is Up

Shortly before we went to press, the Bank of England finally announced its first rate increase in 10 years. This means that the official bank rate is now 0.5% (compared to 0.25%), the first increase since July 2007. According to Bank of England governor Mark Carney, it is likely to rise twice more over the next three years.

The underlying cause of this rate rise is almost definitely inflation. Official data showed consumer prices rose by 3% in the year to September, from the previous month's 2.9% rate. The rise, which took inflation to its highest levels since March 2012, was driven by increasing food and transport prices. The Bank of England has a target inflation rate of just 2%.

As soon as the Bank of England made its announcement, the pound promptly plunged. So what will the likely effect be of the increase in the interest rate on personal finances?

For borrowers it almost certainly means an increase in costs. HSBC had already recently raised interest rates on some of its two-, three- and five-year fixed rate home loans following on similar increases by Barclays, NatWest, Nationwide and Santander. This new interest rate increase will give all lenders an opportunity to widen their margins for the first time in many years. It is also likely that we will see a hardening of rates for fixed rate deals with lenders taking advantage of borrowers keen for certainty going forward.

Fixed rate individual savings accounts (ISAs) have risen faster than any other saving product this month – with the average one-year cash ISA up by 0.04% to 1.04%. However, there is not a single standard savings account on the market that beats or even matches the current 3% rate of inflation. So, although we can expect slight rate increases for savings, it is unlikely that they will come close to matching inflation.

What about pensions? Inflation is bad news for pensioners as it generally erodes any cash savings. However, the increase in rates and inflation should trigger a relatively generous increase for both private and state pensions.

Millions of pensioners will see their state pension payments rise by up to 3% from next April thanks to the triple lock that guarantees the benefit will rise by the higher of September's inflation figure, average earnings or 2.5%.

The stock market has, of course, always proved the best and most consistent way to beat inflation. However, with the UK economy looking a little shaky at the moment some investors may wish to diversify overseas. True, sterling is weak but many commentators feel that it still has further to fall.

Alternative Investment: The REIT Opportunity

If you are a property investor and are reviewing opportunities for indirect investment in the property and real estate sectors then you may have already come across real estate investment trusts (or REITs). A REIT is a specialist tax-efficient investment vehicle built around real property assets and more specifically property rental activities. REITs are quoted companies or groups of companies that own and manage property, whether that is commercial or residential, with the aim of generating a rental income.

The huge advantage of a REIT is that it provides an opportunity for an investor to access and own property assets indirectly… that is to say without having to buy and own physical property assets themselves.

As most of a REIT's taxable income is distributed to shareholders by way of dividends, it is largely exempt from corporation tax, which means that the usual double taxation – corporation tax plus the additional tax on distributed dividends – is eliminated.

The way that REITs deal with taxation makes them a very tax-efficient form of property investment and so potentially more attractive to investors.

Additionally, a REIT will typically spread its investments over several properties, which helps to ease the disconcerting highs and lows which may arise from investing in a single property, with the result that any investment risk involved can be reduced.

UK REITs tend to specialise in specific property asset classes, for example industrial property, commercial property and residential property. One exclusion to the type of property that can be included in a REIT is the letting of owner-occupied buildings.

It is, therefore, important that as an investor you think very carefully about which area best suits your investment objectives, as well as the risk factors associated with those property classes.

The advantages of investing in a UK REIT can be summarised as:

- Tax efficiency: as already stated a REIT is currently exempt from UK corporation tax.
- Improve liquidity: REITs are traded on the London Stock Exchange, online and by telephone.
- Reduced barriers to entry: REITS offer reduced financial barriers to entry and they provide access to property investment vehicles for minimal entry outlay, with opportunities for growth, income diversification.
- Access to high value assets: REITS allow ordinary investors to share in the returns of UK commercial properties such as shopping centres, office space and retail parks.
- Reduced transaction costs: compared to the cost of buying and selling individual property directly, REITs have very low

operational costs.

• Reduced liability: the investor has no liability in the actual management of the property.

REITs were created in the US after president Dwight D. Eisenhower signed public law 86-779, sometimes called the cigar excise tax extension of 1960. The law was enacted to give all investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate in the same way they typically invest in other asset classes – through the purchase and sale of liquid securities.

Since then, more than 30 countries around the world have established REIT regimes, with more countries in the works. The spread of the REIT approach to property investment around the world has also increased awareness and acceptance of investing in global real estate securities.

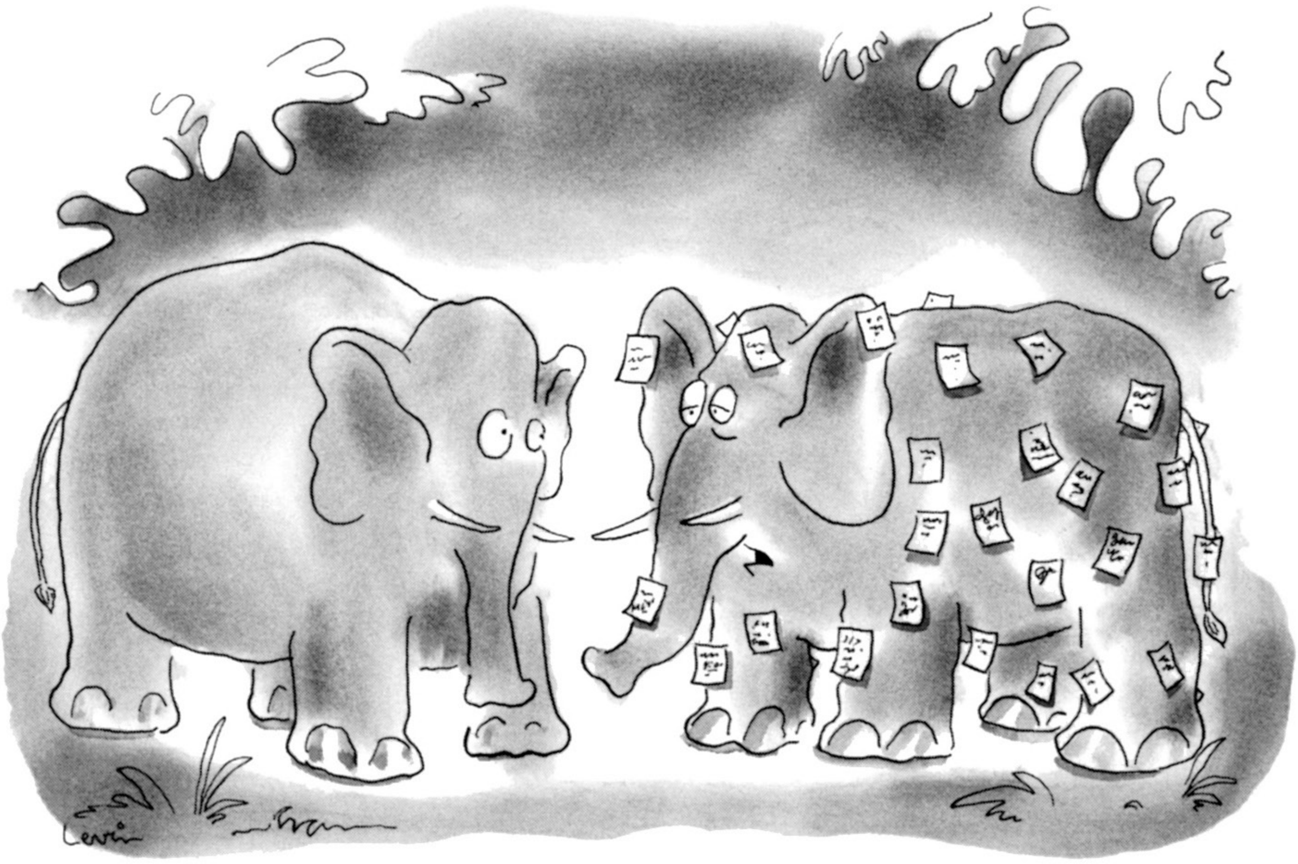
The legislation laying out the rules for REITs in the UK was enacted in the Finance Act 2006 and came into effect in January 2007, when nine UK property companies converted to REIT status, including five FTSE 100 members at that time: British Land, Hammerson, Land Securities, Liberty International and Slough Estates (now known as Segro).

British REITs have to distribute 90% of their income to investors. They must be a close-ended investment trust and be UK resident and publically listed on a stock exchange recognised by the Financial Conduct Authority.

One of the biggest advantages offered by REITs is that they do allow investors to diversify into property markets all around the world. It is also possible to buy an ETF which tracks the REIT market. So you can invest in a basket of REITs, as it were, thus further reducing your cost and reducing your risk.

Incidentally, REIT shares can be held in ISAs and child trust funds and the managers of these can receive gross distributions, making these highly tax efficient.

What about performance? The rate of return will, broadly, reflect the average performance of whatever market the REIT is involved with. So you can expect a large commercial property REIT in India to perform as the commercial property market in India performs. However, it must be pointed out that there can be a wide difference between REIT performances even within the same sector.



"As I get older, I find I rely more and more on these sticky notes to remind me."

Property

Tiny Properties, Massive Opportunities

Marko Rubel, a well-known American real estate commentator, was recently asked by the *Huffington Post* what he thought the hottest property trend was in the world. His answer was "the tiny house movement". He said: "The latest real estate trend sweeping the nation is a very small thing: tiny houses, also known as micro houses, compact houses, mini houses and little houses. Ranging between a compact 100 square feet to the more spacious 500 square feet, the tiny home is a movement centred on downsizing and the notion that you should be able to afford the home you live in."

The tiny housing market has quickly evolved from a quirky project to a serious undertaking. As more and more tiny-home owners share details on their comfortable lives and their tiny homes, many people – particularly millennials – are following suit. Already there have been documentaries and docuseries about the tiny house movement, and new blogs and websites dedicated to tiny housing and their homeowners are appearing every day. There are even workshops teaching people how to build their own tiny house. In America, it is estimated that a tiny house costs anywhere from $10,000 to $40,000 to build, with the average being just $23,000. At such low prices, it is no wonder that 68% of tiny-house owners don't have a mortgage. It has been estimated that millennials are the newest and largest group of potential homebuyers. However, more than 50% rent because they can't afford the initial down payment. Tiny housing, as a result, can be an appealing alternative, particularly since many millennials live alone or don't have children.

Intriguingly, rather than buy a piece of property, which is often expensive, many tiny-home owners in the US rent land. More and more landowners are specifically renting out pieces of their property to multiple tiny-home owners, easily and quickly making a profit.

So, where are the investment opportunities – especially if you live in the UK?

First, if you have limited cash to invest, building and selling or renting tiny houses is an option. Particularly if you are a builder or work closely with one, you can build tiny houses for less and sell them at a profit. Bear in mind that houses take less time to construct and are portable, meaning that you can build them anywhere and the buyer can transport them to wherever they plan on living – even if it is across the country.

Second, if you have the money but not the time, renting out land to tiny-home owners is a simple way to earn a monthly return. If possible, look for land that is flat and spacious. You can split the land into equal square footage, or offer different sizes for different costs. Electricity and water needs would be minimal, as tiny homes are eco-friendly and energy efficient. You would need, however, to find a friendly local authority, although the rules around mobile home parks will help you.

It has to be said that a severe shortage of housing land coupled with strict planning regulations means that the tiny-house movement has not grown quite as rapidly in the UK. However, there is a British equivalent, known as micro properties. The average new-build home in the UK is already the smallest in Europe (excluding Russia), at just 76 square metres. This does not compare very favourably with Denmark (137 square metres), the US (201 square metres) or Australia (a whopping 214 square metres). However, in Hong Kong, the average new-build home is just 45 square metres and it is likely that we British are heading in the same direction.

The number of micro homes in the UK is soaring, as the chronic lack of supply in the property market means that developers are slicing up buildings to create multiple dwellings. These properties, categorise the micro because they are smaller than 37 square metres, have become much easier to produce legally because of permitted development rights (PDRs), which were introduced by the government in 2013. PDRs allow builders and developers to change the use of buildings without the need for planning permission, including changing offices into residential homes. Since the act came into force, the number of micro homes in the UK has soared. Almost 8,000 were built in 2016 (more than doubling from 3,515 in 2010), the highest number on record, according to *Which?* analysis of Land Registry data.

However, buyers are being warned that purchasing a micro property could leave them with a depreciating asset. *Which?* found that these properties don't necessarily grow in value like their larger counterparts, while some mortgage lenders still won't lend on them at all. *Which?* found that the average price of a micro home rose by just 6.9% between 2013 and 2015, while the national average house price rise was 8.7%.

Never mind the capital appreciation, what about the rental returns? According to Central London Portfolio (LCP), there is increasing demand for smaller properties in prime central London which offer an affordable option for tenants who wish to be centrally located near their place of employment or study. Over the last 12 months, 42% of properties let have been either studios or one-beds. On the other hand, demand has been notably slower for larger rental properties as families consider less central options, offering better value and more space. It takes much less time, incidentally, to find tenants for smaller micro apartments. With the growth of the sharing economy many companies are creating micro apartment developments. For example, a company called Inspired Homes is currently creating a 184-unit scheme in Manchester in which prices for a one-bedroom apartment will start at just £132,000. Inspired Homes builds high-tech, high-spec micro apartments typically ranging from 30 to 41 square metres. There is probably no part of the market that they won't infiltrate. They may be tiny but they offer massive opportunities.

The Landlord's Dilemma

One of the trickiest issues for any buy-to-let landlord to deal with is that of subletting. Subletting happens when an existing tenant lets all or part of their home to someone else. That person is known as a subtenant and they have a tenancy for all or part of the property which is let to them. They also have exclusive use of the accommodation that is let to them. Example, if you decide to sublet your home, you are giving up possession of it. The subtenant would have exclusive use of the property and you could only enter it with their permission.

When a property is sublet, the owner is known as the head landlord. The tenant they rent to is called the mesne tenant. 'Mesne' means intermediate and is pronounced the same as *mean*. The mesne tenant then rents to the subtenant.

There is a difference between subletting and lodging. A subtenant and a lodger can both rent rooms, although a subtenant can also rent an entire property rather than just part of it. The main difference between a subtenant and a lodger is that a subtenant has exclusive use of their room. Their landlord needs permission before they can enter the subtenant's room. A lodger's landlord can enter the lodger's room without permission and often does so to provide services such as cleaning.

So, can tenants become mesne tenants and sublet? In most instances, tenants must have their landlord's permission before they can sublet all or part of their home. Most tenancy agreements contain a term on this and as a landlord it is important, if you haven't already done so, to insert it into all your tenancy agreements.

What happens if your tenant sublets without your permission? In theory a landlord can take legal action against the tenant if they sublet. This is because the tenant will have broken a term in the tenancy agreement and on that basis the landlord is able to take action to evict them.

As a landlord, you must follow a specific legal process to evict and this will depend on the type of tenancy that's in force. The process generally involves serving the tenant with some form of written notice seeking possession and, when that notice expires, applying to the county court for a possession order.

In fact, in many cases, if you find that your tenant has sublet a room to a lodger it may simply be better to come to an understanding with the lessee. In particular you could write a letter in which you warn your tenants that they will be personally liable for any damage done to the property by the lodger, responsible for carrying out right to rent checks on the lodger and liable for any costs in obtaining vacant possession. You should also insist that any spare keys cut for the lodger are returned to you at the end of the tenancy to avoid a security breach and, if such an agreement exists, you should ask for a copy of the lodger agreement. You should ask your tenant to sign a copy of your letter confirming that they understand the new terms of their agreement.

A couple of other points: under the general law a house in multiple occupation (HMO) landlord must get a licence from their local authority if their HMO property has three or more storeys and five or more occupiers who form more than one household.

Therefore, in some cases if an extra lodger is introduced into a property it may turn your property into an HMO, resulting in your having to apply for an HMO licence (which costs money and takes time). Under these circumstances it may be worth your while to evict your tenants.

European Buy-To-Let Opportunities

Where do you think the best gross rental yields are to be found in Europe? That is to say, the best gross annual rental income, expressed as a percentage of property purchase price, in other words, what a landlord can expect as a return on his investment before taxes, maintenance fees and other costs? We looked at the available figures for 120 square metre apartments located in premier city centres. We considered only resale apartments and houses, not newly built properties. What we found was that the highest yields were to be had in Moldova (10%), Ukraine (9.09%), Montenegro (7.53%), Ireland (7.18%), Estonia (6.64%), Bulgaria (6.24%), Romania (6.07%), Portugal (5.64%), Croatia (5.63%) and Poland (5.5%). Once one begins to fall below a 5% yield (and Hungary, Slovenia and Cyprus all hover at around that mark), one is really dependent on capital gain in order to make a reasonable return. Indeed, if one allows for inflation, even a 6% yield – allowing for all the costs such as voids, maintenance, inflation, tax, management fees and so forth – is likely to result in a net loss.

Not surprisingly, the countries that offer the highest yield tend to have shown the slowest house price rise. We couldn't actually find the figures for Moldova. In the last ten years, Ukrainian property prices have fallen by approximately 65% and Irish property prices by around 27%. Estonian house prices have been more or less static and only a few countries in the top ten gross rental yield category have actually shown an increase in prices. Amongst these are Macedonia (up 15%) and Poland (up 22%).

What these statistics suggest is that if one is going to follow an investment policy that is linked to timing, the important thing is to buy while property is still relatively inexpensive (and the gross yields are high) so that one benefits both from high return on one's original investment and reasonable potential capital gain. Ireland continues to offer one of the best investment opportunities in Europe because it has got such a stable political environment and such a strong economy. Incidentally, if you were looking outside Europe, the top ten locations by gross rental yield would be:

1. Jamaica, Kingston 9.7%
2. Egypt, Cairo 9.4%
3. Indonesia, Jakarta 9.61%
4. Tanzania, Dares Salem 9.57%
5. El Salvador, San Salvador 8.49%
6. The Bahamas, 8.16%
7. Jordan, Amman 8.13%
8. Ecuador, Quito 8.04%
9. Nicaragua, Managua 7.7%
10. Costa Rica, San Jose 7.48%

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