A SHORT STUDY IN SCHIZOPHRENIA: THE FINANCE ACT 2012 CHANGES TO THE REMITTANCE BASIS RULES[1]

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1. The love/hate relationship of H.M.Government and the foreign tycoon is not new. Half a century ago Harold Wilson was convinced by his very anti-tycoon party and the country's near economic collapse – a forceful combination - to change the rules so as to subject non-UK domiciliaries who were UK resident to what is commonly misdescribed as UK "progressive taxation". Anything less designed to result in progress has yet to be invented. Word got out and a deputation of Greek ship owners of the Onassis, Latsis, Niarchos mold dropped in on No. 10 and politely pointed out a few home truths such as Britain was a mercantile economy (pre Big Bang days), they owned most of the world's ships and they wanted to stay in London. Wilson was nothing if not a pragmatist and the Government's plans were quietly dropped.

2. The Greeks had made their point well and the lesson was not quickly forgotten. The next time round it was not so much an economic crisis which prompted a change in attitude but economic success. Barely more than 5 years ago Britain was booming to such an extent that important elements of political society were telling Gordon Brown and David Cameron that "we don't need these people's money anymore, we don't need to attract them and we don't need, in particular to give them tax breaks". Brown, during his long years as Chancellor had been constantly harangued by colleagues, back benchers and elements of H.M.Government to "soak these particular rich", demands he had withstood with commendable commonsense, until they were inexcusably adopted by the Conservative Party and the ground was shot from under him.

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1 This article is for general guidance only and specific advice should be sought in relation to the application of the subject matter in any particular case.

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3. With hubristic irony however no sooner was the ink dry on this mischievous legislative change, than the UK was facing bankruptcy and needed all the friends and in particular rich friends that it could get. HMRC and its Treasury allies, having taken very careful aim before skilfully shooting themselves in the foot are now trying hard to staunch the wound, before it is too late. And it is quite late too. A very good but small Swiss firm told me that the UK anti non-domiciles legislation had for a period increased the enquiries they were receiving for the resettlement of the international rich in Switzerland from a dozen or so a month to that number per day.

4. It has always seemed very odd to me too that the UK seeks to tax non-domiciliaries on the basis that does most harm to UK economy. I could understand it if they were charged to tax on the basis of income and gains which they took *out* of the UK to spend or invest elsewhere, but it is perversely idiotic to tax them when they do exactly what you want them to do – that is to bring lots and lots and lots of money into the UK. It is rather like clamping a car because it is causing an obstruction, so ensuring it does so for as long as possible.

5. Anyway even the most sceptical of HMRC and Treasury minds now seem to have got round to working that out for themselves, so its about turn again and legislation has now been introduced to encourage non-doms to invest in the UK. Of course some of the very richest had been in the UK for years on exactly that basis – but that was by private arrangement with HMRC and is quite another story.

6. Section 47 and Schedule 12 to the 2012 Finance Act introduce certain changes to the remittance basis of taxation.

   The first amends Chapter A1 of Part 14 of the Income Tax Act 2007 – the "new" remittance basis – in particular it amends sections 809C, H and V and does so with effect from the commencement of the current tax year.
   From now on if you claim the remittance basis for any tax year the charge payable in respect of that year will depend on the taxpayer's residence history in the UK. If he has been UK tax resident in at least 7 of the 9 years preceding that tax year, the charge remains at £30,000, however if he has been resident in the UK in 12 of the 14 years preceding that tax year, the charge increases to £50,000. If the taxpayer has been resident for less than 7 years out of nine there is of course no charge.

7. One might think that these charges are essentially voluntary – which up to a point they are, at least to the extent of being able to time remittances so as to combine them in a single year. But if you think that they are

voluntary because one can carefully select one's years of UK tax residence and thus ensure the offending number is never reached (whilst at the same time remaining substantially resident in the UK) then you have to take very great care. HMRC are enthusiastically applying the "clean break test" as applied by their lordships in *Gaines Cooper* (2011 STC 2249)to temporarily absent non-domiciliaries – and in a significant number of cases it gives rise to difficulty. It is somewhat ironic since the principle is said, by their Lordships following HMRC's arguments not particularly critically, to derive from the ratio of Nichols J in *Reed v. Clark* (1985 STC 323), but if one examines the facts of Dave Clark's case he did *not* satisfy the tests that would now be applied to him to determine his non UK tax residence – so it does seem rather strange that on apparently the same basis he succeeded. However HMRC is enthusiastically confident about its new approach and would-be years of residence selectors will have to take a lot of trouble to achieve their goals.

8. Consistent with its schizophrenic approach to the subject, HMRC has now determined that though remittances are still generally bad they can also be good. In particular they can be good when they are paid to HMRC. So whenever non domiciliaries use foreign income or chargeable gains to pay the £50,000 or £30,000 remittance basis charge directly to HMRC, that income or those gains will not be treated as having been remitted to the UK and will not fall to UK tax charge. This is provided for by new subsection (2) of section 809V.

The new 809V(3) however provides that subsection (2) does not to remittance basis charge payments to the extent they are *repaid* by the Commissioners. This will not happen often but if it does is likely to give rise to an unexpected tax liability.

9. The principal change to the position of UK resident non-domiciliaries in the Finance Act is the provision of an important exception to the general and longstanding rule that income and capital gains from non-UK sources (to use an old fashioned but convenient description) become chargeable to UK tax if and to the extent that they are remitted to the UK. This rule is now qualified by what Part 2 of Schedule 12 to the Finance Act describes as "Business Investment Relief".

10. Section 809VA tells us that if a "relevant event" occurs which would otherwise constitute a remittance and the individual makes a claim for relief under that section, the income or gains concerned are to be treated as not remitted to the UK. The relief applies only to the income or chargeable gains of an individual – not to those of trustees, a foundation or other non-natural entity – which may give rise to some interesting

questions where those income or gains are deemed for certain UK tax purposes to be an individual's.

A "relevant event" is defined as the use of money or property by a relevant person to make a qualifying investment or its receipt in the UK in order to be used by a relevant person to make such an investment – so the money or property does not have to be brought into the UK by the individual concerned. It includes also income or gains that would be treated as remitted by virtue of s.809Y (property which ceases to be exempt).

The qualifying investment must be made within 45 days of the money or property's receipt in the UK – if part but not all of receipt is invested within that period there will be an apportionment on a "just and reasonable basis".

Last but not least the qualifying investment can be of absolutely any amount – most unusually for a tax relief of this sort it is unlimited.

11. Section 809VA(7) denies relief, somewhat oddly, where the remittance is part of a scheme or arrangement the main purpose of which is to avoid tax – one would have thought in that case non-remittance would be the easier option and sub- section (8) provides that the claim for relief must be made on or before the first anniversary of the 31st January following the tax year in which the income or gains would otherwise be treated as remitted – so we are all going to have to brush up on our timing of remittance rules. Why the Act could not have provided that a claim must be made within 18 months or two years of the date of actual remittance, I have no idea.

12. 809VB is perhaps unexpected. If money or property is brought into the UK but not invested in a qualifying manner within 45 days, it does not necessarily fall to charge. If within that period it is "taken offshore" – which essentially just means ex UK rather than to an island tax haven; it will not be treated as having been remitted. If part is taken offshore within 45 days and part not (or not invested) there is another just and reasonable apportionment.

13. What constitutes a "qualifying investment"? In the first place either shares in a company must be issued to the person (meaning presumably the individual, but curiously that is not what section 809VC says) or the person must make a loan (secured or unsecured) to a company. Shares include "any security" but are not defined. HMRC generally regards the issue date of shares as the date of entry of the shareholder in the register of members of the company not – if different – the date of beneficial entitlement to the shares. If monies are to be drawn down under a loan

agreement it is the actual drawdown dates, not the date of the agreement which must satisfy the 45 day test.

Recently HMRC announced the introduction of a voluntary pre-investment clearance process, available through an update of the existing CAP 1 service.

14. Needless to say that is not the end of the conditions. Section809 VD adds the following requirements.

First, the company concerned must be either an eligible trading company or an eligible stakeholder company or an eligible holding company.

An eligible trading company is a private limited company carrying on one or more commercial trades –an interesting new definition – or preparing to do so within the next 2 years (what happens if it then does not?). And the carrying on of such trades must be *substantially* all (I can hear the submissions to the tribunal now) of what the company does or is preparing to do.

An eligible stakeholder company is again private and limited and exists wholly for the purpose of making investments in eligible trading companies (ignoring minor or incidental purposes) and which holds one or more such investments or is preparing to do so within 2 years.

"Investments" has the same meaning as in 'qualifying investments' so includes loans and all sorts of securities – whatever they may be.

An eligible holding company is a company of which an eligible trading company is a 51% direct or indirect subsidiary by reference to its ordinary share capital – so long as the activities of the members of the group as a whole comprise substantially carrying on "commercial trades" – an imprecise definition.

15. Limited liability partnerships are specifically excluded from the relief, and ordinary partnerships are obviously not included. I am not sure why. Neither apparently is HMG, as they have stated that they are looking at the matter, with a view, perhaps, to introducing further legislation in next year's Finance Bill.

What is perhaps a bit surprising, is that the relief is available in respect of investment in any eligible company – defined only by what the company does and irrespective of its ownership or connection with the individual concerned. A non domiciliary can secure the relief by investment in his own company, or his family company or one owned by his children's trustees. It simply does not matter. Neither does the company have to be a UK company. The test is whether the investment would constitute a remittance apart from the present relief and remittance is widely defined by ITA 2007, s809L as including things like the receipt of a service in the UK.

16. Further "commercial trade" is not a restrictive definition so much as an extensive one. Section 809VE tells us that "trade" here means anything that is treated for corporation tax purposes as a trade. Holiday letting springs to mind as giving rise to various interesting possibilities, as well as a business carried on for generating income from land within section 207, Corporation Tax Act 2009 (the exploitation of an interest in land such as the grant of licences and sites for caravans).

A "commercial trade" must be carried on on a commercial basis and with a view to the realisation of profits – so no persistently loss making farms or racehorse studs – but then that is true to constitute "a trade" for tax purposes anyway. R & D from which it is intended a commercial trade will be derived also qualifies – but not *preparing* to carry on such R & D.

17. At this point someone in HMRC thought that generosity might be going over the top so section 809VF introduces Condition B which prevents a relevant person as defined in section 809M (an extensive definition derived from the old close company participator rules but with some surprising omissions such as siblings and grandparents) from obtaining, becoming entitled to obtain or expecting (directly or indirectly) any related benefit. How such an intention is to be discerned is not clear.

However, "benefit" here means only something that would not be and does not include anything which would be, provided on an arm's length basis in the ordinary course of business or would not be provided on those terms. So the payment of substantial salary to the investor is fine so long as it is in line with the market remuneration for what he actually does.

18. A benefit is related if it is directly or indirectly attributable to the investment (whether obtained before or after) and it is reasonable to assume that it would not be available but for the investment. So for example where does that leave dividends? An offending benefit may be anything in money or money's worth – property, services, goods, enjoyment, temporary or permanent.

That said there is considerable scope for the investor to benefit from his investment so long as he can demonstrate – if challenged – that it does not exceed what might be expected in the ordinary course of business between unconnected persons. The general theme seems to be, don't be too greedy and you can enjoy your remittance – subject to whatever UK tax charge – for example on director's emoluments- would normally apply.

19. Section 809VG tells us what happens if income or gains are treated as not remitted under these provisions but a "potentially chargeable event" happens after the investment has been made and "the appropriate mitigation steps" are not taken within the relevant "grace period". The starting point therefore seems to be the "potentially chargeable event", which is defined in section 809VFas:

(1) investment in a non- eligible company;

(2) disposal of all or part of the investment;

(3) breach of the "extraction of value rule"; or

(4) the 2 year start up rule.

20. The first of these is obvious – the company invested in does not satisfy any of the qualifying tests.

The second is simple too - the investment is disposed of.

The third is more worrying. It seems to apply to any receipt of value by the investor or other relevant person, other than a receipt which is chargeable to income tax (or would be if the recipient were chargeable to income tax) *and* – the test is cumulative – which is provided at arm's length on ordinary commercial terms. The offending receipt may be from the target company or various connected companies categorised in 809VH(4). What then of a receipt of value on a liquidation or other capital distribution such as a return of capital? The answer is that sub-section (10) prevents an insolvent liquidation per se from being a chargeable event – but specifically does not prevent the receipt of value in connection with such a liquidation from constituting one.

The rules in respect of the 2 year set up period also seem a bit odd. There is a potentially chargeable event if on the expiry of the 2 year period the company invested in is not operational – unsurprisingly; but also if it becomes non-operational and I quote "at any time after the end of that period".

Does that really mean, 10, 20, 50 years later? What happens if the non-domiciled investor has died in the meantime? Death is not one of the defined "appropriate mitigation steps".

21. The "appropriate mitigation steps", are defined in 809VI. Where the charge would otherwise arise on an actual disposal of the relevant

investment, the charge is avoided if within the grace period the *disposal proceeds* are reinvested (in other qualifying investments) or taken offshore. In other cases the investor must dispose of the whole of his investment and reinvest or take offshore the proceeds up to the amount of his original investment or so much as has had the benefit of the relief. Any gain, it would seem he can retain without charge in the UK. However, this still applies even in the case of a deemed part disposal, an amount equal to the whole of the original investment must be reinvested or taken offshore. There is no provision for apportionment – so in that in the case of a deemed part disposal he may not be able to retain any part of gain in the UK, it is a matter of arithmetic in the particular case.

However, in the case of a potential charge following an extraction of value, he does not have to dispose of the holding and it is only the value received which has to be reinvested or taken offshore.

22. As we have seen the mitigation step must be taken within the relevant "grace period", which is computed – quite complicatedly – by section 809VJ.

Generally the disposal or reinvestment of the original investment must take place within 90 days of the day when the investor first became aware or "ought reasonably to have become aware" of the chargeable event. A date therefore on which minds could easily differ. But where the extraction of value rule is broken it is 90 days from the receipt of that value. In practice this may be a lot easier than disposing of shares in or the benefit of a loan to a private company within a 90 day period – indeed despite the investor's best efforts that may prove impossible. Once the disposal proceeds are available the investor then has 45 days to reinvest them or take them offshore.

23. The draftsman may have been aware of the illiquid nature of private company investments as "an officer of HMRC may agree to extend the grace period in exceptional circumstances" – hardly a reassurance. Apparently HMRC will issue guidance on what they regard as "exceptional circumstances" but as numerous taxpayers have now learned to their cost, Revenue guidance does not form a very reliable basis for any sort of remedy, even judicial review. The guidance will also deal with the procedure for making application for extension of the period and the sort of conditions that might be imposed.

Section 809VJ(5) provides that regulations may be introduced extending the grace period but the examples given were extremely limited in effect, e.g. the case of a "lock up" agreement in respect of a company about to be stock exchange listed or a statutory or regulatory closed period following a company's year end. The regulations made so far (Business Investment Relief Regulations SI 2012/1898) do not extend it any further.

24. Section 809VK sets out the stringent conditions under which part of the disposal proceeds of a qualifying investment can be retained in the UK to meet a CGT liability arising from that disposal without there being a deemed remittance. If the disposal proceeds – these are the actual disposal proceeds not any substituted market value – are less than the sum of the amount that would have to be taken offshore or reinvested to get full relief (often the full disposal proceeds) plus CGT thereon at the highest rate potentially applicable – then so long as the shortfall (and no more) is used within the 45 day grace period to purchase a certificate of tax deposit (confirmed in writing by HMRC) then that deposit will not constitute a remittance.

25. Section 809VL sets out the mechanics of the tax treatment resulting from taking the appropriate mitigation steps within the relevant grace period including the rules where the proceeds of one qualifying investment are reinvested in another – basically the original or underlying investment retains its character throughout and any surplus reinvested is treated as a separate investment. There is no prohibition on reinvestment in the same company as the investment disposed of.

26. VM deals with the mechanics of tax deposit relief. If funds in a certified tax deposit are used to meet the relevant tax liability then the underlying foreign income and gains are not treated as remitted to the UK. However the tax deposit must not be used to pay any other tax liability; if the deposit is withdrawn it must be taken offshore or reinvested within 45 days; and any part of the deposit not used to pay the relevant tax liability or withdrawn by the due date must be withdrawn by the depositor and taken offshore or reinvested within 45 days of the due date.
If these conditions are breached then the underlying income or gains affected by the breach are treated as remitted to the UK.

27. Section 809VN contains the rules on the order in which disposals are made when there are several acquisitions and disposals in the same company or group and there are qualifying and non-qualifying investments. The general rule is that qualifying investments in the same company or group are treated as a single holding and on a disposal or other chargeable event "first in, first out" will apply.

Where there are both qualifying and non-qualifying investments in the same company disposals are first treated as from the qualifying investments until they are exhausted.

28. Section 809VO sets out the special rules which determine how a remittance is to be taxed when the fund from which it is treated as made comprises more than one type of income or gains or income or gains from more than one fiscal year. Again in very general terms what happens is that the remittance is treated as containing the same proportion of income, gains and "pure" capital as there was in the original fund in the first place. So either do not make investments from a mixed fund or make very sure you keep proper and verifiable records of exactly what comes from where. Remember this needs to be done at the time the investment is made, it may be difficult to reconstruct at all convincingly several years later.

29. Section809VO also amends s809Y (exempt property ceasing to be exempt treated as remitted) so as to provide that property which would be treated as remitted as a result of ceasing to be exempt is not so treated if it is used to make a qualifying investment within the period of 45 days from ceasing to be exempt and "the remittance basis user", as he is rather inelegantly described, makes a claim for relief before the first anniversary of the 31st January following the tax year in which the property ceases to be exempt. This relief still applies if the property is converted into money or other property and whether before or after it ceases to be exempt.

30. The remainder of section 809VO first inserts a new section 809Z8 which defines disposal proceeds. If the consideration for the disposal is other than in money "the amount of the consideration is the market value of the thing at the time of disposal". But which thing, that disposed of or the consideration?

If the disposal is not by way of bargain at arm's length (which includes any disposal to a relevant person), then it is clearly specified that the consideration is the market value of what is disposed of. Fees and incidental costs of disposal are deductible.

31. Section 809Z9 explains what needs to be done for disposal proceeds or whatever to be "taken offshore" or invested in a qualifying investment. "Taken offshore" means that the money or whatever is:

(1) taken outside the UK;

(2) ceases to be used or enjoyed in a way that would constitute a remittance.

Interestingly it is *not* necessary that the relevant funds be traceable ex UK or cease to be enjoyed or used in specie – it is sufficient that an amount of equivalent value is exported or reinvested – subject to certain specific exceptions in respect of exempt property.

32. Part III of Sch 12 provides a new exemption for the tax which could otherwise arise on the remittance of income or gains arising on the sale of exempt property in the UK. Any UK gain which arises on such a sale is treated as a foreign chargeable gain. Basically even though the property has ceased to be exempt the relevant income or gains are still treated as not remitted to the UK. The conditions for this treatment are that the sale is not made to a relevant person, is at arm's length, that no relevant person has any subsequent entitlement to benefit from the property, that the whole of the sale proceeds are taken offshore or reinvested in a qualifying investment within 45 days and that a claim for relief is made within the specified time. Succeeding provisions have like effect in respect of the chargeable gains that would otherwise arise on exempt property being sold. "Exempt property" of course means property derived from foreign income or gains which are exempt only by virtue of those provisions – it does not include UK income or gains or property derived from pure capital. But it is still restricted to those items specified in s809X to Z of which the financially important one is "works of art or collectors' items brought into the UK for the purposes of public display at approved establishments", though interesting use may also be made of the temporary importation (less than 275 countable days)and repair or restoration categories.

33. So where does all this leave us? Suppose that Mr. Ivanovich invests £1 million in shares in a new Mayfair gallery "Ivanovich Ltd" exclusively from his foreign income or gains. It turns out to be remarkably profitable and he sells his controlling interest on to Mr. Ling Hu Po for £10 million in 5 years time. His £9 million gain is almost tax free, at least potentially. It does not get caught by the remittance or deemed remittance rules and should be covered by entrepreneur's relief. His original £1 million stake he can reinvest or simply repatriate to sunny Vladivostok and if he is unlucky enough to die before he realises his investment there will be no IHT to pay because of business property relief.

34. What the Government is doing is encouraging the UK resident non domiciliary to bring foreign monies into the UK tax system without suffering any particular disadvantage because the monies are foreign. Once here, those monies effectively will be subject to the same charges and the same reliefs and exemptions as if they had originated in the UK. It is the interaction of those reliefs and exemptions with the new business investment relief which will provide the most interesting opportunities. There is generally no set off between the remittance liability and the purely domestic one, so it is perfectly possible for the non-domiciliary to be caught by both a remittance charge and the ordinary UK domestic tax

charge, for example on an extraction of monies from a company – which could prove a very expensive mistake, for all concerned.

35. For my part I cannot see why the Government does not follow its own logic and simply subject UK resident non-domiciliaries who claim that status to a flat rate annual charge and then let them do what they like with their money. I suppose there are two potential objections to such a course. First it would be considered "politically unacceptable"; but then so once were the unrestricted export of capital and an income tax top rate below 83%; second it would be terribly bad for us, unlike the wonderful complex alternative that our clients will need advice on for years to come.