TaxTalk

Simplifying the complexities of Tax

April 2024

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TaxTalk: April 2024

Changes to the UK non-dom regime

In the Spring Budget the Chancellor announced that the remittance basis for non-domiciled individuals will end in April next year. Make sure you're ready for the new regime.

A new FIG (foreign income and gains) regime based on residence will apply from 6 April 2025. While HMRC's guidance on the FIG is only high-level at this stage, it provides enough detail to consider its potential impact before the release of the draft legislation. Given the scale of the changes it will be important that affected individuals take early advice.

The Government's intentions remain unclear regarding the meaning of 'domicile' in relation to Inheritance Tax (IHT). At the moment an individual's or trust's exposure to IHT on foreign assets is determined by the concept of domicile. We do understand that IHT will follow the FIG regime with a residence-based assessment, but the detail is yet to be released. So long term non-domiciled individuals should seek advice in good time, especially in relation to any trust structures they may have.

Current regime: the remittance basis

Until 5 April 2025, individuals who are UK resident but non-UK domiciled will still have the option to claim the remittance basis of taxation. This means they pay UK tax on their UK sourced income and gains. But they will only pay tax on their foreign income and gains to the extent that they are remitted to the UK.

Anyone who has been resident in 15 out of the previous 20 tax years is deemed domiciled for UK tax purposes and can no longer claim the remittance basis. From this point onwards, they must pay tax in the UK on their worldwide income and gains as they arise. And, at this stage, the individual's non-UK assets enter the scope of IHT.

So from 6 April 2025, the remittance basis of taxation disappears and we will move instead to a residence based assessment. This brings an end to the concept of domicile, at least where income and gains are concerned. Although the implications for IHT remain unconfirmed at this stage, we provide more detail on current expectations below.

The new FIG regime ultimately aims to bring more certainty to the taxation of foreign income and gains of individuals previously taxed as non-doms.

FIG regime for prospective UK tax residents

The FIG regime will apply to individuals who become UK tax resident after a period of at least 10 consecutive years of non-residence. For the first four years of residence, they will be able to choose to be taxed on the FIG regime. In doing so, they will lose their entitlement to personal allowance and capital gains annual exemption.

Changes to the UK non-dom regime

Under the new regime, individuals will not be subject to tax on their FIG regardless of whether these funds are brought to the UK. This means they will not have to track the movement of their FIG to the UK in the way required by the current remittance basis regime. In many ways, the FIG regime will operate like a simple version of the remittance basis.

After these four years, the individual will be subject to tax on their worldwide income and gains.

An individual's residence will be determined as previously, using the Statutory Residence Test.

As with the current regime, overseas workday relief (OWR) will be available for individuals for the first three years of UK residence. But from 6 April 2025 OWR will provide Income Tax relief on earnings relating to work performed abroad, regardless of whether those earnings are brought to the UK or remain offshore.

FIG regime for existing UK tax residents

Shorter-term residents:

Existing remittance basis users who are yet to complete four full tax years of residence can also benefit from the FIG regime. This will rely on them having been non-UK resident for 10 years before their arrival. For example, if an individual is UK resident for the tax years 2023/24 and 2024/25, they will have been resident for two tax years and therefore will benefit from two years of taxation under the FIG regime for 2025/26 and 2026/27.

Longer-term residents:

Existing remittance basis users who don't qualify for the FIG regime will be charged to tax in the UK on their worldwide income and gains arising from 6 April 2025.

Protections from tax on settlor-interested trust structures will also no longer be available for those who do not qualify for the FIG regime. This means that FIG arising in the trust (whenever established) from 6 April 2025 will be taxed on the settlor.

Changes to the UK non-dom regime

Transitional relief provisions:

Knowing that the reforms will hit current remittance basis users the hardest, HMRC is introducing certain transitional reliefs:

1. Existing remittance basis users who have been resident for a period of longer than four years can receive tax relief for the first year of the new regime. For 2025/26, such individuals will only be subject to tax on 50% of their foreign income earned during the year. But capital gains will be subject to tax entirely.

2. Those who have claimed the remittance basis and are neither UK domiciled nor deemed UK domiciled by April 2025 will benefit from a revaluation of their assets for CGT purposes. This would be a rebasing of the assets to their 5 April 2019 value, provided the assets were held at this date.

3. Individuals will be able to elect a reduced tax rate of 12% on the remittance of FIG arising before 5 April 2025 which were protected by the remittance basis. This rate will apply provided the remittances are made in either 2025/26 or 2026/27, but the relief is lost if the remittances are made after 5 April 2027. It will not apply to pre-6 April 2025 FIG generated within trusts and trust structures.

Inheritance Tax

As mentioned, an individual's charge to IHT is currently based on the concept of domicile. Although not yet confirmed, the Government envisages a move towards a residence-based system from 6 April 2025.

Property held personally:

Though still under consultation, the initial discussions suggest that individuals who have been UK resident for more than 10 years will be subject to UK IHT on their worldwide assets. A proposed 'tail provision' would see them remain under the scope of UK IHT for the 10 years after leaving the UK.

Property held in trust:

As with property held personally, the intention is to use the 10-year residence assessment for assets held in trust. The trust will be subject to IHT if the settlor meets the residence assessment at the creation of the trust, at the point of the trust's 10-year anniversary or where there is an exit charge event.

It's likely that the treatment of non-UK assets settled by a non-UK domiciled individual before 6 April 2025, will not change. This means that non-domiciled individuals who come within the scope of the new regime may have an opportunity to keep assets free of IHT.

What should you do next?

At time of publishing, we await further details of the proposed legislation.

Existing and prospective UK residents should use the time between now and 6 April 2025 to acquaint themselves with the new regime. Conversations should start as soon as possible to find out about tax planning opportunities and prepare for residence without domicile.

For further information or advice in relation to any of the issues raised in this article, please contact Stephen Kenny.

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Considerations for landlords facing increasing mortgage interest rates

Landlords are feeling the pinch from new mortgage interest rates. We set out the survival options in the current climate.

Much increased interest rates for mortgages mean that landlords are being forced to aim for high rental income to match their inflated costs. This, paired with greater demand for rental properties, has pushed average rental costs up for tenants by around 8% in the last year.

But even with this surge in demand and increased rents, the interest rate rise on highly leveraged property portfolios can make a significant impact on a landlord’s cash profit.

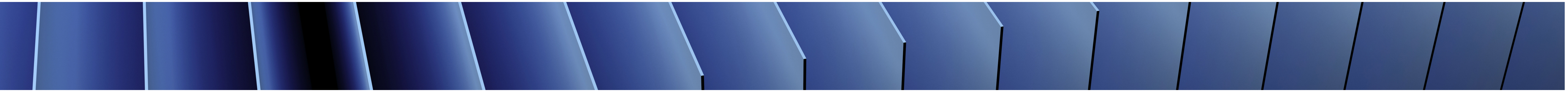
Is it worth being a landlord in 2024?

The estimated annual yield for rent on a London property is around 4% to 6% of the value. As an example, a four-bed property in London is let out as follows:

Property value	950,000	Est. agent fees	12% + VAT
Mortgage value	700,000	Est. annual repairs	£5,000
Est. rental yield (A)	5%	Est. rental yield (B)	6%

Let’s look at two landlord scenarios for this property, one paying 2% on their mortgage, the other paying 5%.

Considerations for landlords facing increasing mortgage interest rates



Example 1 – A 40% taxpayer, with 2% interest only mortgage

The first landlord has a 2% interest only mortgage, paying £1,166 per month. In scenario A, they let this at £3,958 per month, and scenario B at £4,750 per month:

		A (5%)	B (6%)
Annual rental income		**47,500**	**57,000**
Less - agent fee (12% + VAT)		(6,840)	(8,208)
Less other expenses:			
Annual insurance (building & landlord)	300		
Annual safety checks (gas/fire etc)	350		
Annual tenancy documents/changes	750		
Annual repair costs	5,000		
Expenses		**(6,400)**	**(6,400)**
Gross profit (prior to mortgage)		**34,260**	**42,392**
Less mortgage interest – 2%		(14,000)	(14,000)
Less estimated tax position *		(10,904)	(14,157)
Cash profit/(loss) from rental		**9,356**	**14,235**

* Mortgage interest cannot be deducted from profits, instead relief is available at 20%.

		A (5%)	B (6%)
Tax on rental	@40%	13,704	16,957
Less mortgage relief *	@20%	(2,800)	(2,800)
Est. tax liability on rental		**10,904**	**14,157**

Example 2 – A 40% taxpayer, with 5% interest only mortgage

The second landlord has a 5% interest only mortgage, but all other income and expenses remain the same:

		A (5%)	B (6%)
Annual rental income		**47,500**	**57,000**
Less - agent fee (12% + VAT)		(6,840)	(8,208)
Less other expenses:			
Annual insurance (building & landlord)	300		
Annual safety checks (gas/fire etc)	350		
Annual tenancy documents/changes	750		
Annual repair costs	5,000		
Expenses		**(6,400)**	**(6,400)**
Gross profit (prior to mortgage)		**34,260**	**42,392**
Less mortgage interest – 2%		(35,000)	(35,000)
Less estimated tax position *		(6,704)	(9,957)
Cash profit/(loss) from rental		**(7,444)**	**(2,565)**

* Mortgage interest cannot be deducted from profits, instead relief is available at 20%.

Considerations for landlords facing increasing mortgage interest rates

		A (5%)	B (6%)
Tax on rental	@40%	13,704	16,957
Less mortgage relief *	@20%	(7,000)	(7,000)
Est. tax liability on rental		**6,704**	**9,957**

You can see that the landlord's interest only mortgage moving from 2% to 5% has a significant impact on the cash profit they realise. They move from receiving a cash profit, to being in a loss position from a cash perspective. In effect, the landlord is paying to have tenants in the property. But it's also important to note that, for tax purposes, they have made a taxable profit in all scenarios due to the availability of relief on mortgage expenses.

What's more, these examples do not take into consideration those landlords who repay the capital and interest on their mortgage. Only the interest element is available for any relief, so a capital repayment will further reduce the cash profit for the letting. In a year with significant additional expenditure for repairs, this loss could be even greater.

Is it worth keeping their property?

With increasing mortgage rates, I am sure many landlords are questioning whether it's worth keeping the property, with some rentals not even "washing their face". A landlord will need to consider whether the capital investment and potential growth in value are worth the cost of letting.

Where a landlord considered disposing of the property, they must be aware of the Capital Gains Tax (CGT) exposure of this as well. CGT of up to 28% will likely be due on the difference between the purchase costs and the net disposal proceeds. But for disposals after 6 April 2024 this rate drops to 24%. When calculating the gain, it's not possible to deduct the amount of outstanding mortgage.

These property disposals may also need to be reported to HMRC, and tax paid, within 60 days of the sale completion.

What about a company?

Many landlords will jump to the conclusion that moving their properties into a UK limited company will be the best solution, as a company can deduct the mortgage interest before calculating taxable profit. What's more, the Corporation Tax rates are 19% to 20% rather than up to 45% for an individual.

The transfer of a property from a landlord's personal name into their limited company will be treated as a disposal at market value, and the landlord may be liable to CGT. With no physical cash to settle this CGT liability, this can be considered a 'dry' tax charge. A stamp duty land tax (SDLT) charge based on the market value of the property at transfer may also apply.

There may be further complications when the company needs to acquire the mortgage rather than the individual landlord.

Considerations for landlords facing increasing mortgage interest rates

When the company owns the property, the landlord needs to consider how to extract the rental profits. This could be through a dividend, but that may incur tax of up to 39.35%. There can then be significant costs to fund the general administration of the company each year.

Finally, a landlord must consider the 'end game'. In the future the property might be sold, and the extraction of this cash from the company to the individual could be costly from a tax and administration perspective.

What else can I do?

Landlords who aren't interested in selling the property, nor following the complications of a corporate structure, may still have some potential options. Where they have a spouse or civil partner who is paying tax at a lower rate, there may be benefit in transferring all or part of the property into their name.

It is important to note that where spouses or civil partners have a joint interest in a property, regardless of the ownership shares, the default position for tax purposes is to be taxed on 50/50 of the income.

In order to be taxed only on their respective shares, a formal declaration to HMRC must be made, via form 17, providing evidence of the actual beneficial interests in the property. Those couples who have not made a declaration will continue to be taxed on 50/50 of the income.

The other option may be to start short-term letting of the property through sites such as Airbnb. Where a property can satisfy HMRC's formal furnished holiday letting (FHL) rules, mortgage interest from the rental business can be fully deducted against the property. But note that, from 6 April 2025, the FHL regime is being abolished. This will bring even more rental businesses into negative cash positions that were not anticipated.

It's important for landlords to consider very carefully how to try to mitigate the impact of the current increasing interest rates.

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High interest rates: how they affect the Corporate Interest Restriction (CIR)

Due to increasingly high interest rates, more companies are now likely to fall within the CIR regime. We outline what the rules mean, the interaction with other tax legislation and what the next steps are for companies.

Borrowing costs have increased exponentially over the last 18 months. This has put more pressure on businesses to control operating costs, and limited their ability to fund capital investment.

Perhaps a less obvious result is that some interest may not be deductible for tax under the CIR rules.

The Bank of England (BoE) base interest rate is currently 5.25%. The rate has risen at an accelerated pace since December 2021 when it stood at 0.25%. The last time interest rates were this high was during the 2008 global financial crisis.

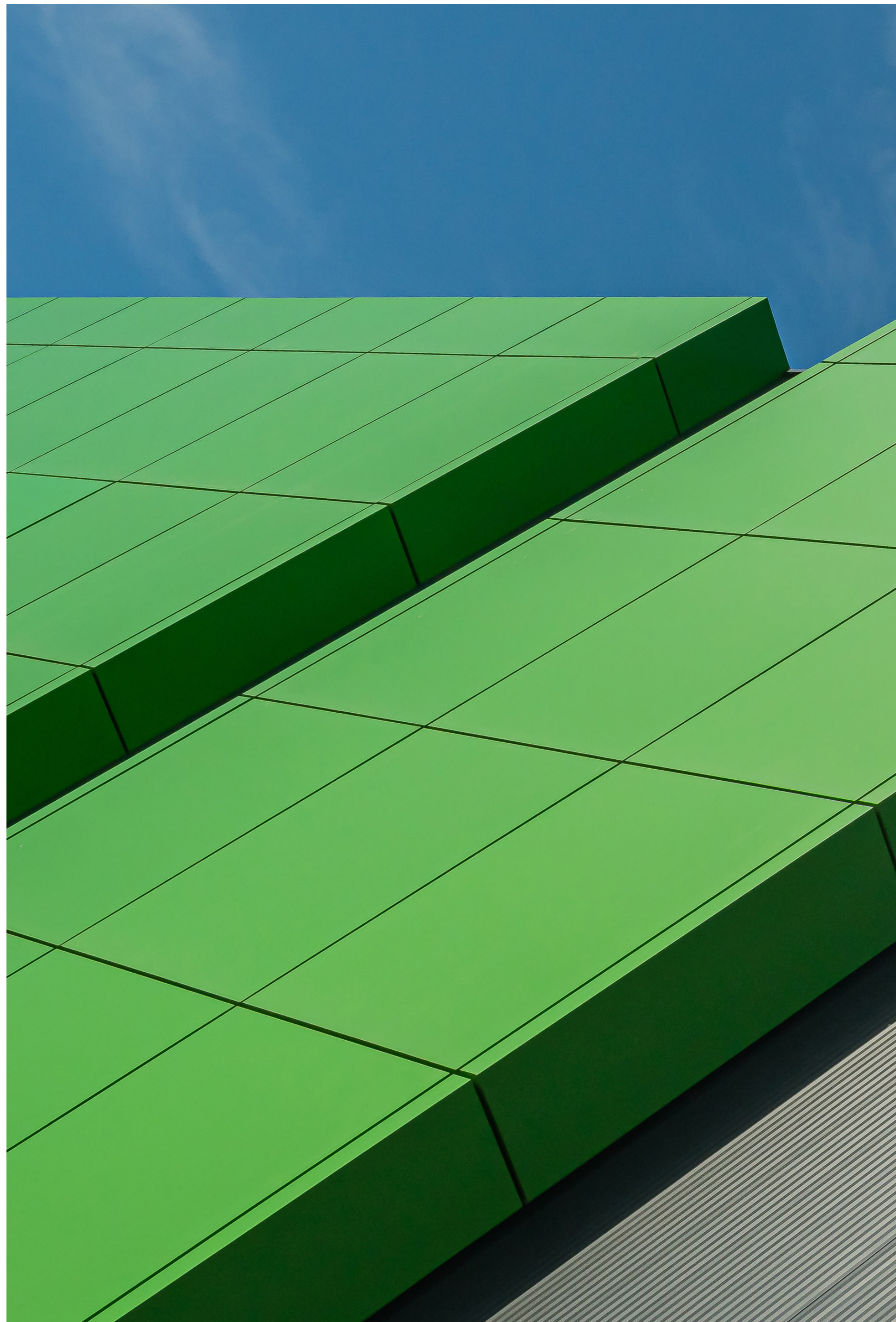
Rising interest rates mean higher interest costs for companies. In the past, when companies could claim full relief for interest costs, their impact was somewhat softened. In the current environment, companies are having to pay much more interest for the same borrowing, and the CIR rules are biting by restricting the deduction of such costs.

The CIR rules: what they mean

The rules were introduced in April 2017, with both companies and advisors adjusting to their complexity since then. Here's a quick recap:

- A UK group (or UK company) can generally claim interest of up to £2m per year without any onerous compliance requirements. This is known as the de minimis limit. Where financing costs exceed £2m, consideration needs to be given to the CIR rules. A CIR analysis may mean some interest costs are not deductible in the company's tax returns. But it's possible some of these disallowed interest costs can be used in the future, subject to certain conditions.
- The £2m CIR de minimis limit has not changed since its introduction in April 2017, when the BoE base rate was 0.25%. Many had hoped that to ease the challenge of high interest rates, this limit would be increased. But sadly it wasn't on the agenda for the Chancellor's Spring Budget this year.
- If a UK group has interest costs of more than £2m, it can elect to use either the fixed ratio or the group ratio, meaning that interest deductions are limited to the higher of the two. Put simply, the fixed ratio allows a UK group to claim interest of up to 30% of its tax EBITDA (earnings before interest, taxes, depreciation, and amortisation). On the other hand, the group ratio allows a UK group to claim interest of up to 100% of its tax EBITDA.
- A UK group can make a public benefit infrastructure election if it meets certain criteria. This may provide the option of higher interest deductions. But groups must judge carefully whether this election is beneficial to them, and that means detailed analysis and calculations.

  A taxable company in the UK can choose this option if it carries out qualifying infrastructure activities (i.e. those providing public infrastructure assets). This requires detailed income and assets tests, prescribed in legislation. The tests are complicated but, broadly, it is possible for companies that qualify to exempt their interest costs from the CIR restriction.



High interest rates: how they affect the Corporate interest restriction (CIR)

Which other tax rules are relevant?

A number of other tax rules interact with the CIR rules:

- The late interest rules which can apply, for example, if the lender falls outside the loan relationship rules or if interest is not paid within 12 months, can cause a delay in the accounting period in which interest is paid. So for groups that have accrued unpaid interest, this may create more issues with CIR. For example, largest payments of interest in a period may be subject to the restrictions.
- If a group has entered into cross-border finance agreements with connected companies, and transfer pricing applies, it's important that the rates used can be supported on an arm's length basis. If there is a transfer pricing adjustment, this may reduce the interest costs that could be deductible for tax and therefore impact the CIR calculations.
- The UK anti-hybrid rules are designed to tackle groups that try to take advantage of local rules either to get tax deductions for payments in multiple jurisdictions, or to exclude income from being taxed. There is separate legislation that covers these rules but, when preparing the CIR calculations, it's important to consider any such arrangements.

UK groups must comply with certain other requirements, such as appointing a reporting company and filing interest restriction returns every year.

What should companies do now?

The CIR rules are contained in part 10 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). They are complex and all UK companies should address them at an early stage in the compliance process. This applies especially where interest is a major component of overall costs.

We are in a period of high interest rates and high inflation. Companies are under increasing pressure to keep costs down to remain competitive. They must also keep a close eye on future cash flow, including payments of tax. Companies should engage with their tax advisors early on, so they can identify any potential challenges in good time.

If you would like further guidance on any of the issues raised in this article, our Corporation Tax team can provide tailored advice based on your business's specific circumstances, please contact Ketan Shah.

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Transfer pricing in a high interest rate environment

Soaring UK inflation and interest rates, the highest for over a decade, mean cost of living pressures and economic uncertainty. What's the impact for businesses and their financing arrangements from a transfer pricing perspective?

Businesses and their intra-group arrangements should comply with transfer pricing rules, which adhere to the arm's length principle. This means that intercompany financing arrangements should be based on terms and pricing which would be agreed between independent parties, based on the prevailing economic conditions. Otherwise intercompany transactions can breach transfer pricing rules and be adjusted by HMRC, with potential exposure to interest, penalties, and economic double taxation.

In a high interest rate environment, UK companies should proactively review, and update where appropriate, their intercompany financing arrangements. We outline below the key transfer pricing and Corporation Tax implications that businesses most commonly encounter.

Thin capitalisation rules

High interest rates have placed greater importance on the pricing of new intercompany debt, including debt pushdown after refinancing of external borrowing.

Thin capitalisation rules look at whether a UK company has more debt than it either could or would borrow without group support, when acting in its own interests in the open market. This can lead to disallowance of any excessive interest deductions claimed by the UK borrower.

Businesses which provide asset-backed lending are particularly affected. In the commercial property investment sector, legacy financing structures with high loan-to-value ratios (that were set up during much lower market interest rates) are difficult to extend on similar terms. Investors are currently placing higher deposits to reduce interest repayments on asset purchases, reducing comparable independent loan-to-value ratios as a result.

What's more, maintenance of debt covenants, such as interest cover ratios, has placed pressure on businesses to reassess their financing arrangements.

Transfer pricing in a high interest rate environment

Financial and performance guarantees

Financial institutions are exposed to various levels of credit risk when lending based on the financial security of a borrower. This is typically determined by the borrower's credit rating.

A UK company with a weak credit rating may facilitate a financial or performance guarantee from a group affiliate (typically a parent company) with a stronger credit rating. This can take the form of a comfort letter, keep-well agreement, or explicit credit guarantee. Each can secure a lower interest rate on external borrowing with significant savings to the UK borrower (or alternatively result in third party costs where a UK company is the guarantor).

Businesses should consider the pricing of intercompany guarantees carefully to avoid the pitfalls. As these arrangements are often complex, it's important to be clear on the specific guarantee, quantify the level of actual benefit, and calculate the arm's length price of guarantee fees based on the economic conditions.

Early repayment and termination clauses in loan agreements

Loan agreements typically include clauses on early repayment and termination, which can be exercised by one or both parties. Following the advance of funds, a UK lender at arm's length may seek to renegotiate to take advantage of an increase in market interest rates. Similarly, a UK borrower on a floating interest rate may want to renegotiate to secure a fixed rate for future certainty.

It's crucial for businesses to review intercompany agreements and consider whether, and to what extent, to re-price or amend their terms and conditions to reflect the current economic circumstances. New loan agreements should also contain relevant fallback provisions.

Business restructuring and asset valuations

As well as financing arrangements, high interest rates can impact other business activities like asset valuations on transfers between companies. In the absence of direct comparables, asset valuations are typically calculated on an income-based valuation method, such as discounted cash flows.

Transfer pricing in a high interest rate environment

A key component here is the discount rate to apply, which considers the time value of monies. This is directly affected by high interest rates. So, it's important for businesses to assess the economic conditions and effects of timing of intra-group asset transfers.

What should you do now?

High interest rates can have major transfer pricing implications for businesses. These can be complex, so should be considered carefully.

As the first quarter of 2024 ends, multinationals should decide whether any transfer pricing adjustments are needed for financial reporting (for calendar year-end companies) or tax return purposes. In our December issue, we discussed the importance of making appropriate transfer pricing adjustments.

Businesses should constantly review whether, and to what extent, the high interest rate environment impacts their existing intercompany financing arrangements. This may suggest a defence requirement for retaining the existing position, the need to reprice, or the setting up of new (and unwinding of outdated) internal financing-related flows.

Any revised intercompany financing arrangements should reflect the latest economic conditions and business facts, supported by transfer pricing analysis and documentation.

For further guidance, please contact Farhan Azeem and Kiran Rai.

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VAT: don't get caught out for being 'careless' – lessons for VAT practitioners and businesses

A significant VAT dispute with HMRC reached the First-tier Tribunal decision stage in December. Mark Ellis focuses on the key takeaways regarding 'reasonable care'.

The dispute between HMRC and Realreed Ltd (which operates serviced apartments Chelsea Cloisters) provides many lessons to VAT practitioners and businesses alike.

It covers how to deal with the letting of dwellings on both a short- and long-term basis. It also asks whether an HMRC VAT inspection that yields no VAT assessments can be taken to be an endorsement of your current/historic VAT accounting. Spoiler alert: it does not. And it gives guidance on what it means to take 'reasonable care' in relation to a taxpayer's approach to its VAT affairs.

So what actually happened? The tribunal ruled that Realreed's letting of apartments did not qualify for the VAT land supply exemption. This was because it provided accommodation in an establishment similar to a hotel or boarding house. And, crucially, it concluded that the company was careless, even though HMRC had not challenged the liability position during any of its compliance visits.

What does 'reasonable care' look like?

Imagine a taxpayer has discussions with an accountancy firm (perhaps as part of its annual audit). Unless this includes a full conversation on the taxpayer's VAT position, with a detailed meeting note and written advice produced afterwards, then there is no evidence that the taxpayer took VAT advice at that time.

A taxpayer should take considered professional VAT advice at regular intervals, and even try to obtain a VAT ruling from HMRC in certain circumstances (albeit it may sometimes be hard to do this in practice). That said, just the demonstration of an intention to seek HMRC's views before a VAT inspection is carried out should be seen to be 'reasonable care'.

VAT: don't get caught out for being 'careless' – lessons for VAT practitioners and businesses

If the taxpayer does take VAT advice then they should refresh it from time-to-time (for example, as their business model changes). This will check whether the previous advice still applies in spite of a change in:

- The taxpayer's fact pattern
- VAT law
- HMRC VAT guidance
- VAT case law precedent.

If a new finance director is appointed by the taxpayer, it's important they themselves consider the VAT position of the business they have just joined (potentially with the help of HMRC or a VAT advisor), rather than simply accepting the position on their arrival, and doing nothing to check that it's correct.

The importance of being proactive

Whilst VAT is a self-assessed tax, it is still policed by HMRC. So a taxpayer wanting to take reasonable care needs to consider, at regular intervals, (with the input of HMRC and/or a VAT advisor) whether its VAT accounting remains correct.

That is the meaning of Self Assessment as far as the Tribunal was concerned in the case of Realreed Ltd. Doing nothing at all, or just carrying on doing what has always been done, is not taking reasonable care.

In my experience, businesses are usually forced to review their VAT affairs in detail either when there's an HMRC check of one or more previously-filed VAT returns, or when undergoing a due diligence exercise on their business (for example, on sale or flotation).

But in order to demonstrate that they're taking reasonable care in the discharge of their VAT accounting duties, businesses should instead proactively self-assess. That means reviewing their VAT affairs regularly, with or without the support of HMRC and/or a VAT advisor.

Only by doing this can businesses avoid the sting of a 'careless error' penalty. These can be up to 30% of any VAT back payment to HMRC as a result of VAT owed to HMRC for previous VAT return periods. And they would likely also have to pay HMRC additional VAT plus interest (currently 7.75% p.a.).

If you would like further guidance on any of the issues raised in this article, please contact Mark Ellis.

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About PKF
Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

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Our tax services At a glance

"By bringing together the extensive expertise and experience of our tax specialists we can provide a fully rounded service that offers excellent value for money."

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VAT and Indirect taxes

Our indirect tax team will support you in meeting your VAT compliance objectives and advise you on any VAT issues that your business faces.

We can ensure that your VAT risk is assessed and managed, and that your VAT recovery is optimised. We can also provide advice and compliance services on other indirect taxes, such as Insurance Premium Tax, Customs duty, and Air Passenger Duty.

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Tax disputes

HMRC is increasing the number and scope of tax investigations into both individuals and businesses, covering all aspects of potential underpayments of tax, including offshore investments, personal and corporate Self Assessment Tax Returns, PAYE and NIC compliance and VAT.

If an issue arises, our trusted advisors will match the right specialists with your needs to provide you the necessary support – whether for a routine HMRC enquiry or a more complex investigation.

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