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TAXATION, LIFESTYLE AND MORALITY

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George Osborne's 2015 "Summer Budget" raised some challenging questions for those who are resident but not domiciled in the UK. For centuries the UK has welcomed wealthy foreigners' contributions to our economy, allowing them to maintain unremitted offshore income and gains outside the UK tax net. The problem is that, economic arguments aside, it is now generally considered unacceptable for such special treatment to be enjoyed indefinitely by people who have become long-term residents, particularly if actually born here.

The clear message to the Resident, Non-Domiciled (RND) community is not only that they will have to pay substantially higher taxes, but that the historic arrangements are becoming increasingly difficult to justify, morally. The implication is that these individuals have a social duty to make a larger contribution to their adopted country.

It is never easy to have a privilege removed, and in this case the proposed changes may have a profound impact on the financial, business and lifestyle arrangements of many wealthy families, particularly those with widespread business interests. For some, the issue is far more than financial, as increased taxation (particularly inheritance tax) may jeopardise their ability to retain control of family businesses that have been built up over decades.

The responses of such families to the changed environment have been varied, but surveys conducted by this firm provide evidence that attitudes are changing:

- Whilst reasonable measures will be taken to mitigate tax, many RNDs accept they will have to pay more.
- Some, particularly the younger generation, accept that there may be a moral obligation to make a bigger contribution.
- Some of those whose initial response was to leave the UK have yet to find an alternative which both has sustainable tax benefits and an agreeable lifestyle. The UK remains attractive relative to most alternative locations.
- Many RNDs have established deep roots and family ties in the UK and have concluded that very substantial savings would be required to justify relocation.
- Those who have already decided to leave are mainly those whose lifestyle is essentially international and whose residence can be changed by a relatively minor adjustment to the time they spend in the UK.

Most families affected will already be exploring their options, but changing attitudes may need to be reflected in the brief they give to their advisers.

Tax planning is no longer an exercise in outwitting the authorities, but rather finding a more balanced approach which takes account of increasing risks and changing social attitudes.

Artificial schemes, which operate within the letter but not the spirit of the law, are increasingly unlikely to succeed. They can also open an individual up to a wider investigation of their affairs, which is usually expensive to deal with, even where there is no wrongdoing.

Now is an ideal time for families to develop an agreed approach and set of guiding principles, accepted by all relevant family members. In particular, the younger generation may take a different view from their parents and, bearing in mind that tax planning spans generations, it is desirable that the arrangements put in place now are acceptable to those who may have to deal with the consequences in years to come.

The following are some thoughts which might help with deliberations:

1. WHAT IS FAIR, AND WHAT IS NORMAL?

The question of what is fair is a tricky one. It can be argued that it is fair that everyone should pay the same rate of tax. Equally, it can be argued higher earners should pay a higher rate of tax, following the mantra "from each according to his ability, to each according to his need." Further still, it can be argued that as an immigrant to the UK, one should only have to pay tax on income arising in the UK: why should the UK government have the right to tax monies hard earned elsewhere in the world?

In this context, it is helpful to look at where the UK falls in comparison to other major economies. Resident non-domiciliaries have, for a long time, been generously treated under the UK's tax regime and the question is whether, following the tightening of the legislation, they are still better off than they might be elsewhere?

COUNTRY	INCOME TAX	CAPITAL GAINS TAX	INHERITANCE TAX	OTHER
United Kingdom	20/40/45% (10/35/42.5 on dividends).	18/28%	Spouse exempt, £325,000 tax free, otherwise 40%	Non-domiciliaries can for up to 15 years claim a) the remittance basis – no tax on unremitted income and gains and b) exemption from IHT in respect of non-UK assets.
United States	Progressive rates up to 39.6%	Generally taxed at 20%	Subject to a current exempt amount of US$5.34 million, tax is charged at 40%	US residents are taxable on their worldwide income and gains. Only very limited provisions allowing short-term residents to shelter foreign assets from tax.
Germany	Progressive rates up to 45%	25%	Rates vary depending on the relationship between donor and donee, as does the tax free amount, and apply to lifetime gifts as well as testamentary giving.	While the principle of testamentary freedom applies, a disinherited heir may claim 50% of the amount they would have been entitled to in intestacy. German residents or those with a habitual abode in Germany are subject to the tax on their worldwide estates.
France	Progressive rates up to 45%. Additional rates of 3% - 4% for income up to/over EUR 1million in certain circumstances.	19%	Spouse exempt, child sibling 45%, other 60%. Forced heirship also applies to certain assets.	Wealth tax payable on assets of over €0.8 million. Heavy social security payments.
Australia	Top rate of 45%.	Taxed at income tax rates. Rate is reduced by 50% for assets over a year old.	None.	Temporary residents taxed on Australian source income and gains only.
South Africa	Progressive rates up to 41% on worldwide income.	Maximum effective rate of 13.65% on SA resident individuals on worldwide gains.	Testamentary freedom. R3.5 million can pass tax free, otherwise 20%. Spouse exemption exists.	Temporary residents/ immigrants can shelter foreign income and gains provided they do not fall within the definition of tax resident in South Africa.

SOURCE: Private Client Tax, Third edition 2015, John Rhodes, Stonehage Law Limited

As can be seen, the UK still has a broadly favourable regime compared to many other major jurisdictions. It is reasonable to conclude therefore that the UK's current regime is relatively fair and normal, and indeed still likely to be more advantageous to RND's than most comparable alternatives.

2. WHAT ABOUT TAX HAVENS?

A tax haven is defined by the OECD as having three key identifying criteria: 1) Nil or nominal tax rates; 2) Protection of personal financial information; and 3) Lack of transparency. On the face of it, these are an attractive proposition for a wealthy individual looking to keep his affairs private and reduce his global tax liability.

The immediate benefits of living in one of these jurisdictions are obvious: little to no income, capital gains, or inheritance taxes and a perceived higher level of privacy and anonymity with regards to assets.

However, for most people, the sheer levels of life upheaval and lifestyle changes required are often the deal-breakers. The day counting; the constant travel; the time spent away from one's family: these things can be, or can become, too much of an additional burden.

It is also clear that the days of secrecy and privacy are over. The Foreign Account Tax Compliance Act (FATCA) is already well under way and the Common Reporting Standard (CRS) has effectively been with us since the start of 2016. This means that most account holders will have details of their holdings and income reported to the tax authorities of their home jurisdiction. Most of the major tax havens have reluctantly already signed up to these arrangements, under pressure from the international community.

Perversely, the only major jurisdiction not currently participating in CRS is the USA, which is relying on FATCA to provide all of the information they need, having forced the world to comply with their legislation!

3. THE MORALITY DEBATE

We must distinguish the morality of the individual from the morality of the law. People increasingly criticise the wealthy even for taking advantage of tax breaks deliberately created by the government and politicians are often keen to exploit this misplaced public ire for a short-term win.

The morality of the law is debateable. One can easily argue that the UK government has no right to tax funds that have been earned overseas, without any reference to the UK. On the other hand, it can equally be argued that if you are a long term resident of the UK and enjoy all the benefits that come with that, you should pay tax in the same way as any other "normal" UK resident.

Recent government policy changes and announcements are consequently designed to ensure that once you become a "long-term" resident, you should be treated for tax purposes on the same basis as those who are UK domiciled. For the time being, the government has determined that 15 years is the "long-term" watershed; less than the 17 years previously set for IHT in 1974, but much longer than any similar initial period in other countries such as Spain or even Israel.

More broadly, objections are frequently raised when wealthy individuals try to use 'artificial' schemes to gain tax advantages that were not intended. A notorious example is the film schemes which took advantage of an intended tax break, but pushed the boundary too far by removing most of the risks which the legislation was designed to encourage. It is not always obvious at what point the line is crossed between an intentional tax break and 'an artificial scheme'.

FOCUS ON FILM SCHEMES

Gordon Brown originally enacted this legislation in 1997 in order to provide a boost to the British film industry, initially for 3 years, although it was ultimately extended a number of times. Initially, this appealed to many as an interesting alternative investment, but eventually people found ways to financially engineer products such that the benefits could be enjoyed by investors with significantly less risk. It is difficult to know when these schemes began to cross the line of acceptability and this may well not have been clear to investors at the time investments were made – it is easy to be caught out when one thinks there is a genuine investment opportunity.

No one is obliged to leave their affairs in such a way that the taxman will get the maximum possible share, but anything done to decrease that share constitutes tax avoidance. It quickly becomes apparent that tax avoidance is a vast grey area and what might or might not be immoral is a subjective question – one man's "morally repugnant" tax avoidance is another man's ISA, or duty free shopping basket. An individual's approach to tax avoidance or mitigation must be based on their own level of comfort.

There have been high profile cases in recent years of people and corporations being exposed for engaging in various degrees of tax avoidance schemes. These range from companies such as Starbucks and Google transferring profits to lower tax jurisdictions and the "K2" scheme (used by individuals to move income offshore), to the swathes of people caught out by the ultimately failed film schemes. These have all been met, rightly or wrongly, by a strong, negative public reaction which has often been reinforced by criticism from the very top of government.

Whether or not you consider these schemes immoral (note that they were all legal), there is another matter to consider here – the issue of reputational damage. It is difficult to put a price on this but for many entrepreneurs, who hold the majority of their assets in their business, the impact of this has the potential to be significant; tarnishing both the name of the business and indeed the family name, which can be a brand in itself.

An individual is entitled to take advantage of tax legislation to whatever extent and in whatever way they are personally comfortable with, so long as they remain within the bounds of the law.

Some may take advantage of all legal means to minimise tax and others only of tax breaks which were clearly intended by the authorities. Some will always seek tax minimisation, whereas others will aim to keep their overall tax bill to a 'reasonable' level, an objective which needs to be defined and discussed with tax advisers.

It is important to note that those with fiduciary obligations such as company directors or trustees have to justify their decisions to their beneficiaries. Bearing in mind their effective obligation to maximise profits, a strong case will have to be made if tax minimisation is not one of their main objectives, particularly if personal moral values are coming into the equation.

4. ANTI-AVOIDANCE

Historically, offshore structures, while often used for tax avoidance, are also used for matters entirely unrelated to tax, including the mitigation of political and/or personal risk, and succession planning. In these matters, the tax consequences are often a secondary consideration.

In some countries, wealthy individuals can face imprisonment and the confiscation of their assets simply for having a difference in opinion with the ruling party. Transferring assets out of your own name and out of the country is thus an obvious way to mitigate this risk.

The relative anonymity of an offshore discretionary trust can also be put to good use in reducing risks for wealthy families. Kidnapping, for example, is a real threat.

Testamentary freedom may seem like a given to many, but there are a number of countries that restrict, to a greater or lesser extent, the ability to decide how one's assets should be divided on death. Several offshore jurisdictions have laws that specifically do not recognise forced heirship and placing your assets into trust can allow you to pass on your estate freely.

In all of these scenarios, the avoidance of tax will be a likely by-product, rather than a driving factor in the planning. Do moral arguments against tax avoidance still stand up here? Even British legislation recognises that anti-avoidance provisions will only apply where tax avoidance is "the main, or one of the main" reasons for the planning.

5. WHAT SHOULD I BE DOING?

In light of the major changes coming, it is a good opportunity to take a step back and look at the bigger picture: to assess one's priorities and consider what level of tax risk one is willing to accept. No-one can predict specific future changes to the tax system with any confidence, but the direction of change is clear. Families can take the opportunity to put in place structures that are reasonably futureproof. The alternative is to adopt a more reactive approach, and try to adapt as the legislation is announced.

Given the constant changes, and the upheaval that they can cause, many families find it useful to agree a strategic framework and set of guiding principles, which help define their approach and philosophy. These provide a benchmark for individual decisions, as well as being a useful guide for the family's tax advisers, in developing their proposals. It is also an important benefit of drawing up such 'policy documents' that the process helps identify and reconcile differing views between family members. The younger generation, for example, often has a slightly different attitude to tax avoidance and, given that they ultimately have to live with the result of any long-term planning, an agreed philosophy makes obvious sense.

WHERE IS MY RISK?

There are a number of areas where an individual taxpayer faces risk. Investment selection is self-explanatory and the closer one pushes the tax boundaries the greater the risk, naturally. However, it is also worth noting that having an excessively low tax bill can also add risk. Not only do you make yourself more of a target for HMRC, you are also likely to receive less leniency and a more thorough investigation in the event of an enquiry.

Such a framework will be particularly helpful to those considering the implications of the changes to the UK RND rules, given the many complex alternatives which could be explored. It will promote sounder, more consistent and more 'joined up' decision making. Greater clarity of purpose will reduce unnecessary debates and thus reduce the costs of professional advice.

6. CONCLUDING THOUGHTS

Ultimately, deciding an approach to tax is a personal issue. There is a danger that personal advisers have engendered a mind-set of minimising tax at all costs, with little regard for anything else.

Individuals need to ask themselves: do I have an idea of the level of tax that I would consider to be acceptable? Am I able to achieve this level of minimisation within the bounds of moral decency? Am I willing to accept a higher level of tax payable in order to reduce the level of risk faced and to continue to enjoy the quality of life I have achieved in the United Kingdom?

With the direction of tax changes undeniably in favour of tighter legislation, fewer legal loopholes and a more focused approach on tax avoidance, there is an opportunity to consider a new, sustainable philosophy and approach, with some clear guiding principles.

FOR MORE INFORMATION

Andrew Nolan
Partner - Head of Family Office

Andrew is Head of our Family Office Division. For over 15 years he has helped families around the globe deal with the complex day-to-day challenges of succession, governance and wealth transfer. He chairs several family councils and also serves as a Key Adviser to a number of high net worth families.

Andrew joined the Stonehage Fleming Group in 1997 and was Head of the Neuchâtel and Zürich offices from 1998 before moving to the London office in 2012. He is a Chartered Accountant and has a BA (Hons) in Economics from the University of Nottingham.

John Rhodes
Partner - Stonehage Fleming Law Limited

John is a Partner of the Stonehage Fleming Group and Director of Stonehage Fleming Law Limited. He joined the Group in 2008 from Macfarlanes, where he was Head of the Private Client Department from 2000 to 2005. During his 40-year career at Macfarlanes John's main areas of practice were trusts, tax and estate planning for wealthy UK and international families.

John studied Law at Jesus College, Cambridge before qualifying as an English solicitor at Macfarlanes, where he was made a partner in 1975. John is a member of the International Academy of Estate and Trust Law and Society of Trust and Estate Practitioners, by which he was awarded a Lifetime Achievement Award in 2006. John is also a trustee of a number of charities with operations both in the UK and abroad.

Christopher Gillman
Senior Associate - Relationship Management, Family Office

Chris is a Senior Associate in our Family Office Division, which provides advice and operational support to wealthy families and individuals using Stonehage Fleming as an outsourced family office. Chris has a particular focus on UK tax. He has over 8 years' experience in the trust field, helping UHNW families to meet their global financial goals.

Prior to joining the Group in 2015, Chris worked for Rawlinson & Hunter, spending time both in the UK, working within the Trust and Private Client Tax departments, as well as spending two and a half years with their Cayman Islands office in their offshore fiduciary services team. He is a qualified Chartered Accountant and a member of the Society of Trust and Estate Practitioners.

enquiries@stonehagefleming.com
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