MACFARLANES

PRIVATE CLIENT UPDATE

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Welcome to the Autumn issue of our Private Client Update. Through this, we aim to keep you informed about recent legal developments that may have an impact on you.

If you have any questions or require more detailed advice about any of the topics covered in this Update, please don't hesitate to contact me or your usual Macfarlanes contact.

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£1M INHERITANCE TAX EXEMPTION – TOO GOOD TO BE TRUE?

It has been announced that there will be a new exemption from inheritance tax which will allow you to claim a tax free allowance of up to £1m on death. This £1m exemption does not, however, apply to everyone and there are various conditions to be satisfied before it can be claimed. It is also being phased in gradually and so the full exemption will only apply to deaths after April 2020.

Broadly speaking, it will be possible to claim the full £1m exemption if:

- you leave your home to a direct descendant (i.e. a child, step-child or grandchild) or the spouse or civil partner of a direct descendant;
- you were married or in a civil partnership and your spouse or civil partner died before you without using their own inheritance tax free allowance; and
- the value of your entire estate is below £2m.

THE £1M INHERITANCE TAX EXEMPTION

This note sets out the three elements which make up the new £1m inheritance tax exemption.

1 The "basic" nil rate band allowance

Everyone has an inheritance tax free allowance which is known as the "nil rate band allowance". The allowance is currently £325,000. It has been this amount for some time and the Government has announced that it will stay at this level until April 2021. It is this allowance which is being enhanced under the new rules.

2 The "residence" nil rate band allowance

From April 2017 it will be possible to claim a "top up" to the basic nil rate band allowance and this is known as the residence allowance.

However, as the name suggests, you need to own the residence in which you live, or have lived, to be able to claim the exemption and it needs to be inherited by a direct descendant on your death. This means leaving your home to your children, step-children, grandchildren etc or their spouse or civil partner.

The extra residence allowance is also being phased in gradually. It will be an extra £100,000 for 2017/18, £125,000 for 2018/19, £150,000 for 2019/20 and finally £175,000 in 2020/21. It will then be increased in line with Consumer Prices Index. It is therefore only after 6 April 2020 that the full residence exemption can be claimed, giving an individual an inheritance tax free allowance of £500,000. This gives you an inheritance tax saving of £200,000.

3 The "transferable" nil rate band allowance

As a result of the introduction of the new residence allowance, if you were married or in a civil partnership and your spouse or civil partner had not used their own nil rate band allowance on their death, then from 2020 it will be possible to claim an inheritance tax free allowance of £1m.

The basic nil rate band allowance, the residence allowance and the transferable nil rate band allowance all combine to give you an inheritance tax free allowance on death of up to £1m.

So, if a married couple leave everything to each other and claim the spouse exemption on the first death, then on the second death the £1m exemption can be claimed (provided all of the conditions are satisfied). This gives you an inheritance tax saving of £400,000.

The potential to claim an inheritance tax free exemption of up to £1m is welcome but the rules are complicated.

LIMITATIONS

The rules relating to the residence allowance are not yet in force and there are issues still to be resolved. In particular, what should happen where a person decides to downsize or sells their property entirely? The Government are consulting on this point but it is proposed that where a person downsizes or disposes of their property after 8 July 2015 then it should still be possible to claim the full residence allowance.

Even if you satisfy the above conditions, the £1m exemption is limited in scope:

- A major limitation is that, if a person's estate is valued at more than £2m, then the residence allowance will be reduced. For every £2 over £2m, the residence allowance will be reduced by £1.

  From April 2020 when the residence allowance is £175,000, if the surviving spouse or civil partner's estate is valued at more than £2,350,000, there will be no residence allowance. Instead, it will only be possible to claim an allowance of £650,000 (assuming the transferable nil rate band is available).

  If the value of your estate is slightly more than £2m, then you may want to give some thought to making lifetime gifts to reduce the value of your estate to below £2m so that your children or grandchildren can claim the exemption (provided you satisfy the other tests).

- The residence allowance is only available if your home is left to a direct descendent or their spouse or civil partner or to certain trusts for their benefit. If you have a will and it is drafted so that your estate passes onto discretionary trusts for a wide class of beneficiaries (including your children and grandchildren), it will not be possible to claim the residence allowance. If you think you may qualify for the residence allowance, then you may want to think about changing the terms of your will so that your home passes direct to your descendant or their spouse or civil partner.
- If you have already given away your home to your children but continue to live there and pay a rent to your children, then it will not be possible to claim the residence allowance. Going forward, however, it is proposed that you will be able to claim the residence allowance in this situation if the gift took place after 8 July 2015. The Government are still consulting on this issue.

The potential to claim an inheritance tax free exemption of up to £1m is welcome but the rules are complicated. Advice should be sought on your personal circumstances to see if it will be possible to claim the exemption.

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DOMESTIC WORKERS: AN IMMIGRATION AND EMPLOYMENT MINEFIELD

When you are looking for a domestic worker to work for you in the UK, be it a cook, a cleaner or a nanny, there are a number of important immigration and employment issues that you must consider. The first relates to whether the domestic worker will be considered to be your employee. If they are, the next step is to ascertain whether they have the appropriate immigration authorisation to undertake the role in question. If they appear to have this, you, as their employer, must see and retain copies of certain documentation that confirm this. This is to ensure you have a statutory excuse against liability for employing an illegal worker if it turns out they do not, in fact, have the right to work in the UK.

CONSEQUENCES OF GETTING IT WRONG

The consequences of getting this wrong can be severe, as two Government ministers have found to their cost. Mark Harper, who was Immigration Minister at the time, resigned when it emerged that his private cleaner did not have immigration permission to work in the UK. Although, he had not committed an offence as the cleaner was deemed to be self-employed, the reputational damage was sufficient to force him to resign. In addition, Baroness Scotland was fined £5,000 for employing an illegal housekeeper. This incident was particularly embarrassing since, as a Home Office minister, she had played a key role bringing in legislation tightening the law on illegal immigrants working in the UK.

EMPLOYED V SELF EMPLOYED

Someone is likely to be your employee if one or more of the following applies:

- you have to find work for them and can tell them what to do and how to do it, even if they are left alone to do the work;
- you pay them a regular amount of money on a weekly or monthly basis rather than when they have done a particular job;
- you have to find someone else to do the work if they cannot do it for some reason, for example they are off sick. But if they have to find someone else to do the work, for example a friend, this probably means they are self-employed; or
- you are responsible for providing most materials to do the work.

So, for example, a cleaner who provides their own cleaning products, who arranges for one of their friends to do the work if they cannot make it and who you only pay when they clean your home is likely to be considered self-employed. Alternatively, a nanny who works for you on a part time basis for two fixed days a week who you pay on a monthly basis and who you have to cover for if they call in sick, is likely to be deemed to be an employee. This is the case even if they work for another family for the other three days a week.

POTENTIAL PENALTIES

If they are not your employee, you would not be liable if it transpired that they do not have the appropriate immigration authorisation to work in the UK. However, as noted above, this can result in adverse publicity for high profile individuals.

If they are your employee, and they are found not to have the right to work in the UK, you could be liable for a civil penalty up to a maximum of £20,000. In addition, if you are found guilty of knowingly employing an illegal worker, you could be subject to an unlimited fine or a custodial sentence of up to 2 years. The new Immigration Bill proposes to strengthen these criminal sanctions by making it an offence to employ someone whom you 'know or have reasonable cause to believe' is an illegal worker. The maximum custodial sentence will also be increased from 2 to 5 years.

OBTAINING A STATUTORY EXCUSE

In order to avoid liability for a civil penalty, you, as the employer, must obtain a statutory excuse by seeing and retaining copies of certain documentation which evidence the individual's right to work in the UK. Examples of acceptable documents are the individual's passport, if they are a British or European Economic Area (EEA) national. If they are a non-EEA national, as well as the individual's passport, an employer should see evidence of the individual's UK immigration status. This may be an endorsement in their passport confirming they have the right to work in the UK or their Biometric Residence Permit, which is a credit card sized document similar to a UK diving licence, which, again, confirms whether they have the right to work in the UK.

The consequences of getting this wrong can be as small as the inconvenience of having to find a new domestic worker but can be as life changing as imprisonment.

You must see the original of the relevant document(s) in the presence of the individual to ensure that the document relates to the individual. For example, any photo contained on the document must clearly be of the individual and any biographical details, such as the date of birth, must be consistent with the appearance of the individual. This must be done before the first day of employment and, once the check has been completed, the employer must retain a copy (either black or white or in colour) of the document(s) and make a note on the copy of the date they saw it.

If the document states that the individual has time limited

immigration authorisation to remain in the UK, you must make a note of the expiry date. You must ensure that, shortly before this date, you undertake a follow up check to ensure the individual has extended their current immigration authorisation or obtained new immigration permission which enables them to continue in their role. If they have applied to extend their stay / for new immigration authorisation and the application has not been approved before the expiry of their current immigration permission, you must contact the Home Office to obtain confirmation that they have submitted a valid application and that they may continue to work for you while the application is being considered.

When undertaking these checks, the UK Home Office does not expect you to act as an Immigration Officer and provides guides on the documents which provide a statutory excuse. You are also not required to become an expert at identifying forged documents. You would only be deemed not to have a statutory excuse if you accepted a forged document that an individual, who is untrained in the identification of false or forged documents, examining it carefully, but briefly and without the use of technological aids, could reasonably be expected to realise is not genuine. Again, the Home Office provides guidance on how to spot a forgery.

SUMMARY

When taking on a domestic worker, there are a number of practical and legal issues that you must consider. These include agreeing the conditions of employment, such as terms relating to confidentiality, pay, sick leave, holiday and so on. However, before dealing with these, it is vital that you ensure that, if they will be your employee, the individual has the appropriate UK immigration authorisation to undertake the role. The consequences of getting this wrong can be as small as the inconvenience of having to find a new domestic worker but can be as life changing as imprisonment.

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LANDLORDS: NEW RESTRICTIONS ON INCOME TAX RELIEF FOR FINANCE COSTS

In his post-election Budget on 8 July 2015, the Chancellor announced a restriction to the finance cost relief that landlords can claim, to alleviate the perceived unfair advantage that buy-to-let investors have over owner-occupiers.

The Prime Minister has been clear that he wishes to increase the level of home ownership in the UK, particularly for those under 40 and landlords in the private rental sector are increasingly being targeted as part of this wider policy objective. The Government also wishes to address the threat identified in the Bank of England's recent Financial Stability Report that the rapid growth of buy-to-let mortgages could pose a risk to the UK's financial stability.

The current position is that individual landlords can deduct all of their finance costs (mortgage interest, interest on loans to buy furnishings and fees incurred when taking out or repaying mortgages or loans) from their rental income received to calculate taxable profits on their rental investments. This means that relief is effectively given at an individual's marginal rate of income tax (be that 20 per cent, 40 per cent or 45 per cent).

Once the restrictions are fully in force from the 2020/21 tax year the Government calculates that 20 per cent of landlords will pay more tax as a result of this restriction.

Individuals (including partnerships and trustees) who receive rental income on residential property either in the UK or abroad and who are higher or additional rate tax payers will have their ability to claim relief for finance costs (referred to in the legislation as "dwelling-related loans") gradually reduced from 6 April 2017. Landlords who are basic rate taxpayers will be unaffected by the changes. Once the restrictions are fully in force from the 2020/21 tax year the Government calculates that 20 per cent of landlords will pay more tax as a result of this restriction.

From 6 April 2017, individual landlords will be able to obtain relief as follows. In 2017-18 the deduction from property income for higher rate purposes will be restricted to 75 per cent of finance costs, with the remaining 25 per cent being available as a basic rate (i.e. 20 per cent) tax reduction. In 2018-19, the deduction for higher rate purposes will be 50 per cent of finance costs, in 2019-20, 25 per cent and from 2020-21 all financing costs incurred by a landlord will be given only as a basic rate tax reduction. If the finance costs exceed the net rental income after other deductions, any excess may be carried forward to following years.

This is best illustrated by way of example. James owns a buy-to-let property worth £500,000. He has an interest only mortgage of £200,000 secured on the property at a long term fixed interest rate of 4 per cent (i.e. his finance costs are £8,000 per annum). James is a higher rate tax payer. He receives £18,000 in rent each year and has other rental expenses of £3,000 each year. All other things being equal, in 2016/17 James will pay £2,800 in tax on his rental income. In 2018/19 he will pay £3,600 in tax and in 2020/21 he will pay £4,400 in tax.

WHAT CAN LANDLORDS DO?

For many landlords, the impact of the change will be alleviated in the short term by the very low interest rates available at present and the phased introduction of the new restriction means that there is no need to make rushed decisions as a reaction to this change. However, there are some ideas which landlords should consider.

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INCORPORATION?

Corporate landlords (even those carrying on a rental business in partnership) are currently unaffected by the changes and given that corporation tax will fall to 19 per cent in 2017 and 18 per cent by 2020, individual landlords could (subject to stamp duty land tax (SDLT) and other considerations) consider transferring personally held rental properties into a company or purchasing new properties through a company.

One benefit of this would be the ability to deduct all finance costs before calculating taxable profits. Corporation tax rates are now very attractive as against income tax rates. The benefit of being able to repay loans out of rental income which has only been taxed at 18 or 19 per cent rather than up to 45 per cent is considerable. Profits could be kept in the company with no need to incur the costs of extraction until they were needed.

However, this is a complex decision requiring detailed advice, which will differ for each portfolio and each landlord's personal circumstances. Where properties are standing at a gain, there could be an immediate charge to capital gains tax when the properties are transferred. One would need to factor in the impact of the annual tax on enveloped dwellings (ATED) charge for properties worth over £500,000. Although let properties are currently exempt from ATED, there is no guarantee that this will be the case in the future.

SDLT rates on purchase can be higher for corporate buyers and landlords will need to take a view on the Government's stated desire to discourage corporate ownership of residential property in general and whether further measures will be introduced in future Budgets to make corporate ownership of buy-to-let properties less attractive.

Corporate landlords may face higher interest rates than individuals and certain lenders may be unwilling to accommodate existing landlords seeking to transfer their properties into a corporate structure.

HOLIDAY RENTALS?

The proposals will not impact on landlords with residential properties which meet all the criteria to be a furnished holiday letting and landlords looking to enter the market for the first time or to expand their portfolio may now be tempted to give careful consideration to this market (with a possible consequential rise in the value of holiday properties).

WEAR AND TEAR ALLOWANCE CHANGES

A further change was also announced in the July Budget and will come into force in 2016.

Landlords with furnished properties are currently able to claim a flat rate 10 per cent deduction from income. This generous relief is available every year, regardless of whether any expenditure is actually incurred.

From 6 April 2016, this allowance will be abolished altogether and replaced with a new relief that allows residential landlords to deduct only the actual costs of replacing furnishings when calculating their taxable profits. Again landlords of furnished holiday lets benefit, as the Government have confirmed that capital allowances will continue to apply to these properties.

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