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technical news

For professionals working with international clients

The political wind has changed on tax avoidance

Tax evasion is illegal. Tax avoidance is within the letter of the law but not the spirit. Tax relief is government-endorsed to encourage good behaviour.

This sounds very obvious, but given the general hysteria over BBC One Panorama's "**Paradise Papers**" programme (on the subject of 13 million legal and financial documents from a Bermuda-based law firm) and the confusion it sparked between what is illegal, what is immoral but legal and what is both moral and legal, it rather needs saying.

Some of the things revealed in the Paradise Papers do look like they should fall under anti-avoidance regulation, so that will keep HM Revenue & Customs happy for a while. Some of the papers released indicate that there is more to be done in regulating some jurisdictions, and that our politicians probably need to put more effort into dealing with extreme avoidance by the extremely rich.

But a lot of the revelations are no more than the long-term result of over-complicated taxation systems and the endless loopholes they generate. The hysteria over them also misses the point that many funds are set up offshore for perfectly straightforward reasons. The structure means they can be sold into lots of jurisdictions, but also that their investors can pay the right taxes in their country of residence without being caught in someone else's tax system (and administration) along the way. Nothing wrong with that.

There is more room for hysteria over the behaviour of the world's big companies and their impressive tax-avoiding expertise. However, they are doing things that are not so much illegal as really irritating. It is also worth remembering that governments and voters are on to them. There are all sorts of schemes afoot to bring them into line and get them to pay whatever sovereign states reckon is their fair share.

That won't happen overnight, but it will happen. According to the OECD, legal tax avoidance strategies such as the ones used by Apple, Nike and the like cost governments some $240bn a year. They could do with the cash.

However, while the papers and the coverage around them should be seen mostly as an unnecessary distraction, they still matter. That's because they are a clear signal – to those who still needed it – that the political wind has changed.

Evasion was always out. Now, avoidance is too. If you are evading tax, today is the time to come clean: you do not want to be an enemy of state in this environment. The new Common Reporting Standard (CRS) now allows information on you and your money to flow freely all over the world. That means it is only a matter of time until you are caught.

If you are evading or avoiding, don't for a second comfort yourself with the thought that no one will ever know. If the Paradise Papers tell us anything at all, it is that they probably will know your financial privacy is gone for good. We live in a new world in which everyone's personal affairs are considered fair game.

At first glance, this looked like a much smaller scandal than the Panama Papers two years ago. Back then, the huge leak of documents from offshore law firm, Mossack Fonseca, uncovered many shell companies that were being used for tax evasion, getting around sanctions and other outright illegal activities. The leak from offshore law firm Appleby has mostly just revealed some awkward but legal details about the financial affairs of everybody from the Queen to pop stars.

The headlines about this fresh leak will only increase the perception that too many of the wealthy are able to avoid taxes in a way that's unfair when everyone else is struggling.

The main lesson, however, might be that if there are offshore law firms who have not yet reviewed their cybersecurity systems, it would be wise to do so very quickly. This climate is worrying in many ways. We might all end up suffering if we demonise the entire principle of confidentiality and justifying the

hacking of any financial information. But the grievance is justified and governments need to respond by getting to grips with abuses of the tax system. That involves closing preposterous cross-border loopholes. It requires more sharing of information between international tax authorities. It means putting more pressure on offshore financial centres (including some British territories) to improve transparency. But it should also entail having fewer, better rules.

Tax codes have become more complex (Britain's tax code has trebled in the last 20 years). That complexity creates only two things: work for accountants and lawyers and opportunities for them to find loopholes on behalf of wealthy clients. Neither are good for the rest of society.

And yet, along with a string of other massive leaks of offshore data, they don't actually reveal anything very much that is genuinely illegal. What they do show is something that should worry us all a lot more: that financial confidentiality is being destroyed. When every piece of data is routinely stored online, and every computer is connected to the internet, any kind of account can be hacked into, or the data transferred to a simple USB stick, and then published online for anyone to take a look at. We should be very careful about allowing that. People have a right to privacy in their financial affairs as much as in any other aspect of their lives. There are perfectly legitimate reasons for individuals or companies to keep bank accounts private.

Such as? They may have family members or spouses to placate. Parents don't always want their offspring to know exactly how much money they are giving to anyone else, and wives might want to keep some financial details secret from their partners, and vice versa. Companies might choose to have an offshore subsidiary because they don't want to reveal the details of their finances to their rivals. Or they might want to keep information back from employees or suppliers. Those are all good reasons why bank accounts are kept confidential.

With the Paradise Papers, someone took vast quantities of data – estimated at 13.4 million records – from the law firm Appleby and handed it over to the German newspaper Süddeutsche Zeitung, which then shared it with papers around the world. That sounds like theft of private information. When the "Panama Papers" were leaked to the same organisation last year, the source was an anonymous individual who claimed he or she was fighting global inequality. A disgruntled employee? A lone hacker? A former client? We have no way of knowing.

Is this the beginning of the end for the buy-to-let property market?

It looks as though a growing number of landlords are throwing in the towel and putting their properties on the market. A combination of the end of tax relief, rising stamp duty and the fear of rising interest rates may finally have proved too much for the once-booming buy-to-let market.

So what happens now? Is this enough to crash the housing market – or will it continue to totter along in suspended animation?

Growth in the total number of outstanding buy-to-let mortgages is no longer keeping up with growth in the number of new buy-to-let loans being written.

In other words, even although new landlords are arriving on the scene, other buy-to-let loans are being paid off at an increasing rate. As a result, overall growth in the market is slowing.

This strongly suggests some buy-to-let mortgages are being redeemed as investors sell rental properties. Whilst this is, by no means, an exodus, it is clear that the combined range of tax measures is causing some people to re-evaluate whether or not buy-to-let is for them.

Landlords get tax relief on the interest they pay on their mortgages. So, if you have an interest-only mortgage, you can offset your monthly mortgage payments against your monthly rental income, and only pay tax on the excess.

But that's changing. George Osborne announced a slow-motion end to this tax relief when he was chancellor a while ago, but it's only starting to kick in now. That potentially means a much higher tax bill for landlords.

It's hard to see why landlords would want to expand right now.

Of course, this is not a surprise. Indeed, it's hard to see how it could fail to happen. Put simply, the reduction in tax relief means that anyone buying an investment property with a mortgage, now needs the property to generate a higher yield than before in order to turn a profit after tax.

For yields to rise, rents either have to go up or prices have to go down (or a bit of both). Landlords' pressure groups always argue that anything which increases the costs for landlords will drive rents up. However, this just can't be true, since they are just like any other service provider in a relatively free market: they will charge what the market can bear. So logically speaking, the rents that they charge should (on average) already be as high as they can go, given levels of competition and tenant demand.

Therefore, if rents are already at the highest level possible (or thereabouts), then the only thing that can drive yields up is for prices to go down. Until now, amateur landlords have been willing to hang on to their homes as long as they are covering their costs every year. If the property has ended up costing them money one year, it doesn't matter – the paper profits they've made on the capital gains side more than make up for it. So their 'mental accounting' is still biased in favour of ownership.

But it's going to become ever harder to square that circle. As soon as they fill in their next self-assessment form, some of the most marginal landlords are going to get a nasty shock. And all of this is before we start taking account the fear of further interest rate rises, or the more general crackdown on lending requirements for buy-to-let mortgages, or even the 3% added stamp duty that anyone who still fancies getting into the market has to fork out.

The bigger picture still depends on the course of interest rates. This of course still leaves cash buyers. They aren't affected by the tax relief issue, and they might be willing to suck up the extra stamp duty. However, they are still affected by the fact that yields simply aren't all that appealing right now. And they are also affected by the fact that – weighing up the likely direction of interest rates, not to mention the political uncertainty in the UK right now – the environment simply looks pretty ugly for over-priced residential property today.

Could a buy-to-let exodus drive a severe house price crash?

Buy-to-let has become a much bigger part of the UK market in the last 20 years or so. And we could also see pockets of 'forced' selling (where the landlord effectively has to sell fast in order to get a money-losing asset off their hands before it costs them anymore).

So a crash – probably not. But a bumpy ride and the odd localised bargain? Most definitely.

Budget promotes riskier assets

Long-term savers are breathing a sigh of relief following the recent Budget: not only did pensions tax relief escape the chop, despite warnings of cuts, but investors in tax-efficient venture-capital trusts (VCTs) and the enterprise-investment scheme (EIS) also got an unexpected boost.

VCTs and the EIS provide people with valuable tax breaks to encourage investments in small, unquoted companies where there is a substantial risk of investors losing their capital. However, ministers have become anxious that some of the companies that currently qualify for inclusion in the schemes' portfolios are actually very low risk – and therefore shouldn't need tax incentives to attract funding. As a result, the chancellor plans to introduce more generous investment limits for both schemes.

First, from the April 2018-2019 tax year onwards, investors in the EIS will be able to invest up to £2m a year, twice as much as the current limit, as long as their additional contributions go into 'knowledge-intensive' companies – broadly, those businesses where a significant proportion of cost is accounted for by innovation and research and development. The change means the wealthiest investors will qualify for tax relief of up to £600,000 a year from the scheme.

The contribution limits for VCT investors, meanwhile, will remain the same, but the funds will in future be permitted to invest up to £10m in each knowledge-intensive company in the portfolio, up from £5m previously, giving managers more investment options.

The quid pro quo for these concessions is a test that will prevent the schemes putting money into less risky assets.

Many in the industry had expected the generous tax treatment of both schemes to be curtailed, particularly as VCTs and the EIS are now seen as potential alternatives to private pensions, where tough caps on contributions are hitting wealthier savers' ability to invest as much in retirement plans as they would like. Consequently, EIS and VCT managers have given the Budget changes a cautious

welcome, though the government has yet to provide details of its crackdown on low-risk assets.

The Bitcoin bubble: bursting is only a matter of time

The near-vertical price rise of bitcoin, the digital currency, has been likened to the Nasdaq bubble. But there's really no comparison.

Since bitcoin started trading in 2010, its inflation-adjusted annual average return has been 411%; its best yearly performance, 2013, saw a real return of 5,426%. This is nothing like what can be expected from a stock-market. The best real annual performance by a stock-market on record is Norway's 167% jump in 1979.

As far as valuation goes, at the height of the dotcom insanity, the Nasdaq index had a trailing price-earnings ratio of 175. Bitcoin's earnings are the transaction fees it generates. Divide the total of these in the past year into the market cap, and you get a trailing p/e of more than 710.

As with all bubbles, "the underlying technological revolution is real", as The Wall Street Journal's Aaron Black points out. Bitcoins are based on block-chain, which could "change how commerce is conducted by cutting out the middleman". Block-chain is a digital, encrypted cloud-based ledger that records all transactions across a chain of computers – an Excel spreadsheet that can only be modified with the agreement of others, essentially.

As all transactions are recorded and transparent, there is no need for an intermediate entity to verify them and deal on others' behalf. People could trade stocks with each other. Beyond finance, people will be able to rent car-rides and houses to each other without the likes of Airbnb and Uber.

Still, bitcoin is hardly the only application of block-chain; there are more sophisticated versions. And there are certainly other digital (or 'crypto') currencies out there too.

Bitcoin fans say they have scarcity on their side, because the company says it will only ever produce 21 million bitcoins. But while the supply of bitcoins may be fixed, the supply of ways to invest in them (and other cryptocurrencies) is not. Futures contracts are on the way, and exchange-traded funds are sure to follow. As more and more people access the investment, the rarity value will recede. This mirrors what happened in the dotcom bubble. People could only invest in the advent of the internet through a handful of dotcoms at first. As more and more joined the party, the illusion of scarcity dissipated and the bubble burst.

For now then, bitcoin is "basically a stock that will only ever have 21 million shares and never pay a dividend" according to Neil Wilson at ETX Capital. "Investors' only hope is selling it on to a greater fool – the very essence of a massive bubble."

Contact us

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