Taxation of UK Non-Domiciled Individuals

frank hirth plc
international tax and accounting services

Draft Legislation

On 18 January HM Treasury released the draft legislation heralded by the Chancellor of the Exchequer in his Pre-Budget Report of 7 October 2007 as it relates to residence and to non-domiciled individuals. A very short period of consultation remains open until 28 February. These proposed rules will have significant consequences for all UK non-domiciled individuals resident in the UK, those planning to move to the UK and any individuals regularly here but non-resident at present. Indeed, these changes represent the most significant changes in this area of taxation in living memory. The final legislation will have effect from 6 April 2008 which allows only a very short period for review, reflection and considered action.

Remittance Basis of Taxation

The headline act of Mr Darling's October announcement was the proposed introduction of a £30,000 annual charge for individuals wishing to elect the remittance basis of taxation after a number of years of residence. This is included in the draft legislation and now seems certain to come into effect for the tax year 2008/09:

- The £30,000 fee will apply to individuals who are not domiciled in the UK and who are resident in the UK for the current tax year and for seven of the previous nine tax years. Resident here means for any part of a tax year so the charge will apply to an individual resident in the UK before 5 April 2002.
- The £30,000 is the price of choosing the remittance basis. A charge to income tax and capital gains tax will continue to be calculated on amounts that are remitted.
- The election to be taxed on the remittance basis in respect of employment income, investment income, and capital gains will be made as part of the tax return filing for 2008/09.
- The fee has one small de minimus exception where overseas income is below £1,000; such individuals will automatically be taxed on the remittance basis.
- The alternative to electing the remittance basis is to be taxed on the arising basis in the UK on worldwide income.
- The election is annual so the taxpayer can be on an arising basis for one tax year and elect the remittance basis the next year. Income that arose in a year when the remittance basis applied but which is not remitted until a year assessed on an arising basis will still be caught.
- Any individual electing the remittance basis, however long they have been resident in the UK, will lose the benefit of their personal allowance for income tax and their annual exemption for capital gains tax.

A husband and wife are taxed separately in the UK and so the election and the £30,000 fee will be individual to them. Likewise any children who are not domiciled in the UK and with substantial investment income outside the UK would also be liable to the £30,000 to elect the remittance basis. If the monies used to pay the £30,000 are themselves from funds remitted, then such funds will be charged to UK tax.

The doubt as to whether the charge can be offset against taxes in other countries is acknowledged by HM Revenue & Customs simply stating the onus will be on each individual country to consider whether the levy falls within the terms of the Double Taxation Agreement (DTA) with UK.

For those who are US citizens it seems very unlikely that this £30,000 will be available as a foreign tax credit on their US tax return. There is some concern that by a US taxpayer not electing the remittance basis and thereby mitigating their foreign liability, the additional UK tax incurred has some prospect of not being available for credit.

There are further changes to the remittance basis of taxation that were described in the Pre-Budget Report as the correction of a number of anomalies. Most significant amongst these would appear to be:

- An end to the ceased source doctrine that no income tax liability can apply to a remittance if the source of those funds had been closed during a prior year and therefore does not exist in the following year when remitted.
- To eliminate room for differing interpretation the statute will now define the order in which different elements of income and capital are to be considered as remitted. A particular development appears to be that, where proceeds from the sale of an asset that realised a capital gain are remitted, the entire gain will be treated as brought into the UK before any of the capital element. The ordering applies on a current year basis so it would appear that a last in, first out basis applies to remittances from a mixed account.
- The remittance basis of taxation applies to assets as well as liquid funds. An asset, such as a car or a work of art, purchased outside the UK using offshore funds and subsequently brought into the UK gives rise to a charge to tax on the income used to acquire the asset at the point the asset is brought into the UK.
- Gifts of offshore income made to connected parties outside the UK will give rise to a charge to tax on the donee should that donee bring the funds into the UK. Currently, under anti-avoidance rules, there is only a tax charge if the donor enjoys the benefit of the funds in the UK.
- An individual must maintain his non-resident status for five years to be clear of UK income tax on sums that are brought into the UK following departure (similar principles already exist for capital gains tax); if not, the sums will become chargeable in the year of return.

Non-UK Trusts

Settlors

Currently UK residents who are not domiciled in the UK are explicitly excluded from the anti-avoidance provisions that apply to tax gains of UK domiciled settlors and beneficiaries of foreign trusts. The proposed legislation will change this, undoing a good deal of tax planning with one stroke and requiring much painstaking review and analysis in a very short timescale.

8 Coldbath Square
London EC1R 5HL
tel: 020 7833 3500
fax: 020 7833 2550
mail@frankhirth.com
www.frankhirth.com

From 6 April 2008, any capital gains realised in a foreign trust will be attributed to the UK resident non-domiciled settlor if that settlor retains an interest in the trust. Interest is broadly defined in this context.

- Gains realised on UK assets will be taxed on an arising basis.
- Gains on non-UK assets will be taxable on a remittance basis if such basis has been elected.
- If the gains are not remitted then they will be attributed to capital payments made to beneficiaries.

Beneficiaries

Under current rules, the trustees of a non-UK trust can appoint capital to beneficiaries who are resident but not domiciled in the UK without any UK tax consequences. This is regardless of what capital gains might have been realised within the trust, even if these gains relate to UK assets.

The draft legislation proposes that non-domiciled beneficiaries will be treated in the same way as UK domiciled beneficiaries. Capital gains realised by the trustees of a non-UK trust will be attributed to capital payments made to the beneficiaries and subjected to UK capital gains tax:

- It is important to note the remittance basis does not apply in making these proposed changes to the taxation of these beneficiaries. The attribution rules dictate that the charge to tax applies when the capital appointment is made. This is regardless of the situs of the asset upon which the gain is realised by the trust.
- Additionally, the need to match capital gains to capital payments and the absence of any transitional provisions from the draft legislation mean, although effective 6 April 2008, the legislation may very well have retrospective implications.
- If capital payments made to a non-domiciled beneficiary prior to 6 April 2008 (when such payments were beyond the scope of UK tax) have not been matched by capital gains realised by the trustees in the same period, then the beneficiary will be subject to capital gains tax as soon as the trust realises gains after 6 April 2008.
- If there are undistributed capital gains in the trust and a capital payment is made to the beneficiary after 6 April 2008, then the gains realised by the trustees before the legislation was in effect will be matched against the capital payment. These gains become chargeable to capital gains tax on the beneficiary at the time of the capital payment.
- To the extent that capital gains arising to the trustees prior to 6 April 2008 can be matched against capital payments made to beneficiaries prior to 6 April 2008 (which in many cases is no small task), then the settlement can enter the new regime clean.

Draft legislation published 24 January confirms the intended introduction of an 18% flat rate for capital gains tax effective 6 April 2008. To the extent old gains are matched against capital payments made to a non-domiciled but UK resident beneficiary there is an additional charge of 10% per year over a maximum of six years. This gives a potential effective rate of 28.8% on gains within offshore trusts that have not been distributed prior to April 2008.

Non-UK Companies

Under current rules, non-UK domiciled individuals are excluded from the anti-avoidance rules that attribute gains realised in certain non-UK companies to domiciled residents. The proposed legislation brings these UK resident non-domiciliaries within the same rules as the UK domiciled residents:

- The rules apply to a foreign company that, if it were a UK company, would be considered a close company.
- After 6 April 2008, a UK resident but not domiciled individual with a greater than 10% interest (directly or through ownership with connected parties) in such foreign company will be attributed any capital gain realised by the company in proportion to his interest.
- If the gain is realised on a UK asset then the charge to capital gains tax will be on an arising basis; if a non-UK asset the charge will be on a remittance basis, if it has been elected.

An important point to note here is that where an offshore company holds a non-domiciled individual's home then principal private residence relief will not be available to relieve the gain, or portion of the gain that relates to the period of ownership by the company.

The interaction of the changes to the non-UK trust and company rules means that structures where the company is owned by the trust will flow through to the settlor or to the beneficiary of the trust.

Residence and Days Counting

It has been accepted Revenue practice to exclude days of arrival and departure from the calculation of UK presence days when determining whether or not an individual is a UK resident for tax purposes. On a days counting basis an individual is considered resident if he spends 183 days or more in the UK in any one tax year (statutory), or if he averages in excess of 90 days per year in the UK over a four year period (non-statutory).

The draft legislation now includes the requirement to count days of arrival and departure when looking at the 183 day test; an entrance and exit in the same day will now constitute a day of presence. The 90 day test remains but it has not been chosen to make this statutory. This change will have a significant impact on frequent visitors in particular.

What Needs to be Done Now

The foregoing is intended only as a general summary of what appear to us to be the most significant aspects of the draft legislation published in respect of residence and domicile as we anticipate it impacting the tax affairs of most of our clients and contacts.

Given the extremely limited time we have until these new rules come into effect, we must consider what action needs to be taken based only on draft legislation which has the prospect of further changes through to a point well beyond 5 April 2008 when final enactment will occur. All our non-domiciled clients should consider how these provisions might affect their own position either in the short or medium term. In the meantime we plan to contact clients with offshore trust or corporate arrangements that we are aware of in the next few weeks to help evaluate the situation. No action should be taken based upon this summary alone and we would urge you to contact us, or to speak to a lawyer, about any issues you feel might affect your own position.

Please speak with the director or manager in our team that is your usual point of contact or alternatively, address your questions with Paul Hocking, Nick Shore or Mark Walters:

Paul Hocking: paulh@frankhirth.com Nick Shore: nicks@frankhirth.com Mark Walters: markw@frankhirth.com

Telephone number: +44 (0) 20 7833 3500

This newsletter has been written for the general interest of our clients. It is therefore essential to take advice on specific issues. We believe that the facts are correct as at January 2008 but there may be certain errors and omissions for which we cannot be responsible.