budget

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Welcome to this special edition of Focus. On 18 January, HM Treasury released the draft legislation that had been announced by the Chancellor in his Pre-Budget Report of 7 October 2007. The changes to the taxation of non-UK domiciled individuals included dramatic proposed changes to the taxation of distributions from non-UK resident trusts. Many advisors and professional organisations called for any new rules to be delayed until 6 April 2009 to give HM Revenue & Customs, as well as taxpayers and their advisors, sufficient time to fully appreciate the impact of any new legislation and make any necessary changes to their current arrangements.

In the Budget on 12 March, Mr Darling confirmed that the changes would mostly be effective from 6 April 2008. He also announced that the taxation of UK resident non-domiciled individuals would not be "substantially revisited" for the rest of this or the next Parliament. Hopefully, this will give some comfort to those who are concerned that the new rules will be just the beginning.

The Budget includes some major alterations and concessions to the rules as set out in the draft legislation regarding offshore trusts, the day counting for UK residency, the £30,000 levy and also some helpful changes to the anti-avoidance provisions around remittances and this Budget special edition concentrates predominantly on these areas which are key to our clients. Partly as a result of these changes, there are still areas where draft legislation is yet to be published and so the position is not clear-cut.

The £30,000 Annual Charge

From 6 April 2008, the £30,000 charge applies to individuals who are not domiciled in the UK, who are resident in the UK for the current tax year and for seven of the previous nine tax years and who seek to continue to be liable to UK tax on the remittance basis for overseas income and gains.

There have been some significant changes to the rules regarding this charge. The charge will not apply to children until the UK tax year in which they become 18. Also, individuals with overseas income or gains of under £2,000 will automatically fall under the remittance basis without paying the £30,000 charge; (the draft legislation provided this exception for those with overseas income or gains of under £1,000).

The nature of the £30,000 has now changed; previously it was considered to be effectively a levy and it was likely that it would not have been a creditable foreign tax on a US tax return. The Budget has defined the £30,000 as "a tax charge on unremitted income and gains (or a combination of the two) rather than a stand-alone charge". The taxpayer can choose what foreign unremitted income or gains the £30,000 is paid on and so effectively 'self-assess' whether the charge is an income or capital gains tax.

As a result of the change in the nature of this charge, the UK Treasury is confident that the £30,000 will be available to claim as a foreign tax credit on a US tax return and has included a detailed opinion from a US law firm to this effect. However, there has still not been any formal agreement from the US on this – hopefully a discussion regarding this issue will be on the agenda when the UK and US authorities are scheduled to review the Double Tax Treaty later this year. Therefore, at this stage, it is not clear-cut whether taxpayers will be able to claim and, more relevantly, their personal circumstances in many cases may prevent them from claiming the benefit of the £30,000 charge as a foreign tax credit on their US tax returns.

Remittance Rules

Non-UK domiciliaries who are UK resident and claim the remittance basis of taxation will no longer be entitled to certain personal allowances and the annual capital gains exemption as from 6 April 2008. This will affect all taxpayers who claim the remittance basis regardless of the length of time they have been UK resident.

As set out in the Pre-Budget Report Focus, many of the perceived loopholes in the remittance rules have been closed down with effect from 6 April 2008. There have been no changes to the "ceased source" rules as set out in the draft legislation; any income from a ceased source that is remitted to the UK post 5 April 2008 will be taxable in the UK.

The deminimus amount for unremitted foreign income and gains did increase from £1,000 to £2,000, which results in individuals being subject to the remittance basis automatically without having to make a claim to pay the £30,000.

Property and Services

New legislation will be brought in so that not only cash but also property and services derived from relevant foreign income brought into the UK will be treated as a remittance to the UK. However, the Budget introduced some new exemptions for personal effects (clothes, shoes, jewellery and watches), assets costing less than £1,000, assets brought into the UK for repair and restoration and assets in the UK for less than a total nine-month period.

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Works of Art

The Finance Bill 2008 will also set out that works of art, purchased overseas from unremitted and untaxed employment income, capital gains or relevant foreign income can be brought into the UK for public display in an approved establishment and will not be considered a remittance under the new rules. Works of art that are not on display but are held by approved establishments for the public to see or for educational purposes will also be covered by this exemption.

Gifts

The Budget announced less onerous changes to the rules governing the alienation of income and gains than those set out in the draft legislation. The Finance Bill 2008 will introduce legislation to change the tax treatment when a taxpayer arranges for cash or property to be brought into the UK or services and benefits to be provided in the UK which are funded out of untaxed foreign income or gains. The legislation will ensure that where the taxpayer or their "immediate family" benefits in any way, then the taxpayer will be taxed on that cash transfer, property, services or benefits under the remittance rules.

An individual's "immediate family" is now defined to be spouse, civil partner, individuals living together as spouse or civil partner and their children or grandchildren under 18. This definition also includes close companies or foreign companies that would be close if they were UK resident of which any of these individuals are participators and also include trusts of which any of these individuals are the settlors or beneficiaries. The final legislation could include further changes and so this is one of the areas where further clarity is needed. So, whilst at first glance, it appears that gifts can be made outside the UK to adult children and then remitted to the UK without a tax charge, this may not be the case once the final legislation is drawn up.

Mixed Funds

Legislation will establish clear statutory rules for determining how much of a transfer from a mixed fund (containing capital, untaxed foreign income and gains and taxed income and gains) is treated as the taxpayer's income or chargeable gains and how these amounts will be chargeable to tax. The Budget notes advise that these rules will be more comprehensive than those in the draft legislation.

Offshore Mortgages

HM Revenue and Customs had advised that they would be seeking to treat as a remittance any unremitted foreign income or gains used to meet interest payments in respect of a loan on UK property. However, the Budget has introduced some grandfathering provisions in respect of existing arrangements. The Finance Bill 2008 includes provisions such that untaxed relevant foreign income used to meet interest repayments on "existing" mortgages secured on a UK residential property will in fact not be treated as a remittance from 6 April 2008. This exception will have effect for the shorter of the remaining period of the loan or until 5 April 2028. However, care needs to be taken as if the terms of the loan are varied or if any further advances were made after 12 March 2008, then this exception will no longer apply and the repayments will be treated as remittances from that point.

Capital Losses

The perceived anomaly whereby non-domiciled taxpayers could not set off foreign capital losses against foreign capital gains even where the remittance basis was not claimed, has been "fixed" by the Budget. Individuals taxed on the arising basis who have not claimed the remittance basis from 2008/09 will be able to claim relief for their foreign capital losses in the UK. Individuals who pay the £30,000 charge and claim the remittance basis from 6 April 2008 will be able to make an election to enable them to claim relief for their foreign capital losses in years that they are taxed on the arising basis. This election will be irrevocable and it will require individuals to disclose details of all unremitted capital gains.

Foreign Dividend Income

As from 6 April 2008, if a non-UK domiciliary elects the remittance basis and brings foreign dividend income to the UK, this will be taxed at 40%. In comparison, foreign dividend income assessed on the arising basis will be taxed at 32.5%. This change is to correct a previous error in the law.

Under current rules, UK resident individuals who receive dividend income from UK resident companies are entitled to a non-refundable tax credit (10% of gross income) against the tax due on this income. From 6 April 2008, UK resident individuals with small shareholdings in non-UK resident companies will also be entitled to the 10% tax credit. This rule will extend to other UK resident individuals from 6 April 2009.

Therefore, individuals who elect to be taxed on the arising basis will ultimately pay 15% US tax in respect of their US dividend income and a further 7.5% UK tax – a combined tax rate of 22.5%. However, taxpayers who continue to opt for the remittance basis will ultimately pay a combined tax rate of 40%.

Offshore Funds and Other Non-UK Investments

On a practical note, there are likely to be some difficulties in ascertaining the UK tax treatment of some foreign investments for those taxpayers electing to be taxed in the UK on the arising basis. For individuals being taxed in another country, such as the US, it may be important to align the dates that income or gain is recognised so that UK and foreign taxes are paid around the same time to enable the appropriate double tax relief to be claimed.

New legislation in the Finance Bill 2008 will impact the UK taxation of offshore funds. It is important to bear in mind that the current definition of an offshore fund is likely to change in the future and the Government intends to include a revised definition in the Finance Bill 2009. Currently, offshore funds are offshore collective investment vehicles which are resident outside the UK and which roll up income, rather than distribute it. Any profits on disposal of the fund are taxed as income at 40%. However, if the fund has been certified by HM Revenue & Customs as a qualifying fund (which until now has meant that the fund is required to distribute at least 85% of its income), the gains arising when the investor disposes of his interest is taxable at more favourable capital gains tax rate.

Draft regulations at the time of going to press were to be published on the conditions that an offshore fund must now meet in order to qualify for capital gains treatment. The Budget notes do set out that these funds will no longer have to make a distribution but will have to "report" income to investors who will then be subject to UK tax on the reported income. It is hoped that many of these funds will in future be taxed under these rules which will of course be of benefit to those taxed on the arising basis.

Day Count for the UK Residence Test

Presumably as a result of lobbying, a less stringent definition of a day of presence in the UK for residence test purposes has been adopted. Any day where the taxpayer is present in the UK at midnight will be counted as a day of UK presence. There is further good news as the exemption for passengers who are in transit between two places in the UK has been widened. Days spent in transit will not be counted as days of presence in the UK, even if the taxpayer is still present in the UK at midnight, provided that the taxpayer does not engage in activities that are to a substantial extent unrelated to their passage through the UK. So, if the taxpayer were to attend a business meeting, then the transit exemption will not apply. This exemption has been widened to accommodate individuals who need to change airports or terminals in the UK or who need to switch between modes of transport.

Taxation of Offshore Trusts

The Budget included some very welcome changes to the capital gains tax regime for non-resident trusts that were significantly different from those detailed in the draft legislation. It is important to remember that these new rules apply to all non-UK domiciled taxpayers, not just those who have been resident in the UK for the current UK tax year plus seven out of the last nine years.

The draft legislation sought to introduce taxation of non-UK domiciled settlors of non-UK resident, settlor interested trusts in a very wide and draconian set of circumstances which would overturn existing structuring in many circumstances. However, the Budget announcement is very different from the original proposals.

Settlors

The UK legislation contains provisions to impose tax on the settlor in respect of gains made by trustees where the settlor is UK domiciled. Any proposal to extend this to non-domiciled settlors has been abandoned so that any question of capital gains tax will be assessed only under the legislation to tax beneficiaries.

Beneficiaries

There has been a very important concession to the draft legislation governing the taxation of distributions to non-UK domiciled beneficiaries. If a resident but not-domiciled beneficiary of a non-resident trust receives a capital payment or a benefit which can be matched against capital gains, this payment will now be taxable only to the extent that a capital payment or benefit is remitted to the UK. The Budget notes make it very clear that "this will be so whether the trust gains accrue on UK or non-UK assets".

The Budget has clarified that if capital payments received after 5 April 2008 are matched with trust capital gains realised prior to 6 April 2008 or to the pre-6 April 2008 portion of any capital gain on a rebasing election (see the following section), they will not be subject to tax unless the beneficiary has become both UK resident and UK domiciled. The Budget notes stress that this is regardless of whether the non-UK domiciled beneficiary is being taxed on the arising or on the remittance basis.

Also, if a surplus capital payment made to a beneficiary before 6 April 2008 has been carried forward from the 2007/08 year in order to match against capital gains by attribution in a later year, these gains will not be taxed where the beneficiary has become both UK resident and UK domiciled at the time the trust capital gains are treated as accruing to the beneficiary.

Rebasing

Trustees of trusts which are non-UK resident on 6 April 2008 will have the option to elect to rebase trust assets and assets held in underlying companies on 6 April 2008. This is a potentially invaluable election as these assets will be deemed to have been re-acquired at market value on 6 April 2008.

Previous discussions with the Treasury had touched on the possibility of rebasing provisions but there was real concern that this would only be available to a limited number of trustees. However, the Budget notes make it clear that provided the trust is non-resident on 6 April 2008, this election is available "whatever the domicile of the settlor". The rebasing provision will only impact trust gains treated as accruing to non-UK domiciled beneficiaries; gains accruing to UK domiciled beneficiaries will not be able to benefit from a rebasing election.

The election cannot be made on an asset-by-asset basis but instead will apply to all assets of the trust and those of any underlying companies. The election will be irrevocable and the deadline for making the election will be by 31 January following the UK tax year during which the first of the following occurs:

- A capital payment is made to a UK resident beneficiary (or a UK resident person treated as a beneficiary); or

- A part of the trust fund, which is less than the whole, is transferred after 5 April 2008 to a new settlement in circumstances where the gains are treated as being transferred into the new settlement.

Matching Rules

In terms of matching trust gains with capital payments made after 5 April 2008, a "last in, first out" (LIFO) rule will apply in order to calculate the supplemental charge to tax. For capital payments made after 5 April 2008, the following rules apply:

- Trust gains which arise in the current year and on which a payment is made will be treated as accruing to the beneficiary before gains of previous years and trust gains arising in the preceding year will be allocated to the beneficiary, dealing with most recent years first.

- Capital payments made in the current year are matched with trust gains before capital payments of previous years. Where there have been capital payments in previous years, the trust gains will be matched with most recent years first.

There is an important exception to the LIFO rule in circumstances where rebasing election has been made. Should there be surplus capital payments brought forward from the 2007/08 year, they will be treated in the following ways:

- Where the surplus arises from periods prior to 12 March 2008, matching will be made to gains treated as accruing pre 6 April 2008 on a rebasing election being made prior to matching to post 6 April 2008 gains.

- Any surplus capital payments from periods prior to 12 March 2008 can be matched against post 5 April 2008 trust gains. Any capital payments made after 6 April 2008 will be matched to trust gains arising in the new year first under the new LIFO ordering.
- Transitional rules apply on a special basis to deal with capital payments between 12 March 2008 and 5 April 2008. Where these are not matched against trust gains arising prior to 6 April 2008, as a consequence, they will not be tax under the new rules. They will not reduce the pool of gains for 2008/09 and subsequent years, although for rebasing purposes, the pool at 5 April 2008 will be reduced by the gains attributable to this earlier period.

In Brief:

– Gains of Offshore Companies

The tax treatment is as set out in Focus which covered the draft legislation as there were no significant changes proposed in the Budget. It is important to note that the rebasing election does not apply to assets held by offshore companies.

– Capital Allowances

It was previously announced in 2007 that certain availabilities of capital allowances would be phased out or eliminated on a phased basis from April 2008.

So the writing-down allowance on plant and machinery in the general pool reduces from 25% to 20% (there will be immediate relief for up to £50,000 under a new Annual Investment Allowance). However, the rate for relief on long-term assets will increase to 10%. Industrial and Agricultural Building Allowances have been available over a 25-year period at 4% per annum but we now enter a phase-out period for these allowances until they are withdrawn fully in April 2011. There are various green allowances with 100% first year allowances in energy efficient technologies available.

– Controlled Foreign Companies

There are certain changes being made to the control tests of a Controlled Foreign Company (CFC) to prevent the uses of offshore entities such as offshore trusts where decontrol was previously achieved by use of shares with voting rights but minimal profit or asset rights on a winding up.

Income arising within a trust will be included with profits of a CFC where the assets were settled by the UK company into trust with members of the group being beneficiaries. There are also changes to the holding company rules where income accruing in a partnership or trust will need to be included where the company is entitled as settlor or beneficiary.

Finally, an acceptable distribution policy from 12 March 2008 will only be satisfied if it includes profits accrued in the partnership to which the company is entitled.

– Entrepreneurs Relief

The capital gains tax reform including the Entrepreneurs Relief was set out in the March edition of Focus.

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 April 2008 but there may be certain errors and omissions for which we cannot be responsible.