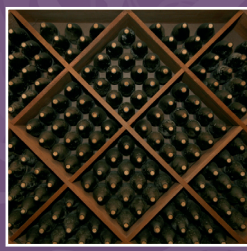
RECOMMENDED BY
INSTITUTE OF DIRECTORS

7th edition

THE HANDBOOK OF PERSONAL WEALTH MANAGEMENT

How to ensure maximum investment returns with security



Consultant editor: ***Jonathan Reuvid***

KoganPage

Taxation of UK resident non-domiciliaries

3.3

PATRICK HARNEY, FORSTERS LLP

The Finance Act 2008 introduced radical changes to the taxation of resident non-domiciled individuals. This chapter seeks to provide an overview of those changes and some practical tax planning advice for non-domiciliaries. Despite the changes introduced by the Finance Act 2008, the UK remains a fiscally attractive jurisdiction for well-advised non-domiciled individuals.

Overview

UK resident and domiciled individuals are subject to UK income tax and capital gains tax on their worldwide income and gains, and to UK inheritance tax on their worldwide assets. By contrast, UK residents who are not domiciled in the UK are able to enjoy a significantly more favourable tax treatment as follows:

1. Access to the 'remittance basis of taxation' on foreign income and gains (albeit subject to the payment of a £30,000 tax charge, in the case of long-term residents);
2. Non-application of some of the capital gains tax offshore anti-avoidance legislation;
3. Inheritance tax on UK assets only, coupled with the possibility of insulating all assets from inheritance tax even where the non-domiciled individual subsequently becomes UK domiciled or deemed domiciled.

What is the difference between residence and domicile?

Domicile must not be confused with nationality. In general terms, a person may be said to be domiciled in the place where they have made their permanent home.

Domicile, in English law, has a more technical meaning than is the case in most other jurisdictions, particularly continental jurisdictions where the concept is closer to that of habitual residence. A person is domiciled in a jurisdiction rather than in a country. Thus, in a federal system, such as for example Australia, a person is domiciled in a particular state.

A person will be regarded as a resident in the UK if:

1. they stay in the UK for more than 182 days in any tax year. This is the overriding rule; or
2. they visit the UK for an average of 91 days or more per year over a period of three or more consecutive tax years. In this case, for short-term visitors, residence status starts usually from the beginning of the fourth tax year. Residence may begin before that if the person intends to make such visits and actually does make them.

Unfortunately, the view of HMRC in their booklet HMRC6 (http://www.hmrc.gov.uk/cnr/hmrc6.pdf) is that spending less than 91 days on average over a three-year period in the UK does not of itself guarantee non-resident status. It states that other factors are also relevant, including an individual's connections to the UK such as family, property, business and social connections. In short, professional advice should be taken in order to ascertain the UK residence status of an individual.

What is the remittance basis of taxation?

The remittance basis of taxation is a special tax regime that applies to non-domiciled taxpayers who make an election in their tax return to be taxed on the remittance basis and pay the £30,000 remittance basis charge, if applicable. Where a non-domiciliary has elected to be a remittance basis user, they are subject to UK taxation on their UK income and gains and on their foreign income and gains to the extent that these are remitted (ie brought in) to the UK. An individual may decide each year whether or not to make a claim. If an individual decides not to elect for the remittance basis, by default, they will pay income tax and capital gains tax on an arising basis in the UK on their worldwide income and gains.

The £30,000 remittance basis charge: what is it and when must it be paid?

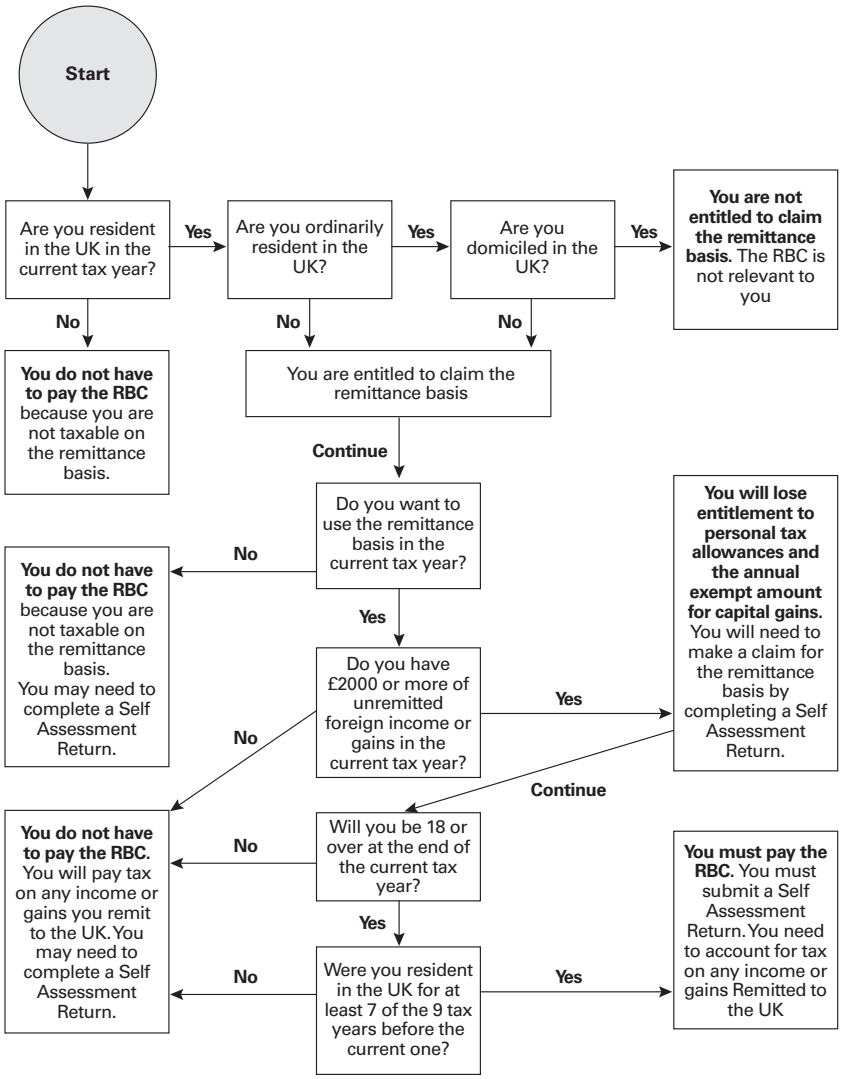
This is an annual tax charge of £30,000 for access to the remittance basis of taxation. It is in addition to any UK tax due on either UK income and gains or overseas income and gains remitted to the UK. The remittance basis charge must be paid by an adult non-domiciliary who has been UK resident for seven out of the previous nine UK tax years and who wishes to be a remittance basis user in a given UK tax year.

Generally, top rate (50 per cent) taxpayers will need to have overseas income in excess of £60,000 per annum to justify paying the £30,000 charge. As the claim to be a remittance basis user will be made on an annual basis, it will be important to plan when a non-domiciliary should make the claim and pay the £30,000 and when they should

not. In years when the non-domiciled taxpayer has significant foreign income or gains, the claim should be made but their affairs could be managed to ensure that in some years, foreign income and gains are limited to avoid the need to pay the charge.

Figure 3.3.1 contains a chart (prepared by HMRC) which sets out whether the taxpayer needs to pay the remittance basis charge.

FIGURE 3.3.1 Do I need to pay the remittance basis charge (RBC)?



Note: The flowchart is a broad guide to help you decide if you need to pay the Remittance Basis Charge. You have a choice each year whether to claim the remittance basis. If, in a particular year, it would be more beneficial for you to pay tax on your worldwide income and gains than to pay the RBC, you may chose not to claim the remittance basis.

The remittance basis charge needs to be paid when the non-domiciliary is filing their UK tax return (ie by 31 January following the end of the tax year for which the return is being made). At that time the remittance basis user will normally have to make a payment of £45,000 (£30,000 plus £15,000 as a payment on account for the following tax year, assuming they are UK resident in that tax year and nominating income rather than capital gains to pay the charge).

The mechanics of the remittance basis charge require the remittance basis user to nominate a portion of their income or gains that is deemed to bear the remittance basis charge. The remittance basis charge then effectively represents income tax, capital gains tax or a combination of the two (depending on the nature of the nominated funds). If the nominated foreign income or gains on which the remittance basis charge has been paid is subsequently brought into the UK, the remittance basis user will not be taxed again on that income. However, should the nominated foreign income and gains be remitted, ordering rules apply, which provide that, in any year, previously unremitted foreign income or gains will be considered to have been remitted before any of the nominated foreign income or gains on which the £30,000 charge has been paid. A planning point here may be to keep a separately identifiable portion of income, chosen to bear the £30,000 charge, in a separate account.

As the £30,000 charge will be classified as either income tax or capital gains tax, it is hoped that it should be treated as such for the purposes of any double taxation agreements to provide relief against any tax which might be levied in the individual's country of domicile on the source income.

The remittance of £30,000 from foreign income or gains to pay the remittance basis charge is not itself deemed to be a remittance provided it is paid directly to HMRC. However, if it is first transferred to a UK bank account and then paid to HMRC, a remittance will have occurred. Since this chapter was first written, the remittance basis charge has been increased by the 2011 Budget to £50,000 from 6 April 2011 for taxpayers who have been resident in the UK for 12 years or more.

Consequences of electing for the remittance basis

An individual who makes a claim for the remittance basis to apply in any year will not be entitled in that year to any personal allowances when computing their income tax liability; nor will they be entitled to the annual exempt amount for capital gains tax (£10,600 for 2011–12). This does not apply to individuals whose unremitted foreign income and gains are less than £2,000.

In practice, for those earning taxable income of more than £112,950 this is not an actual downside because they would have lost their personal allowance due to their level of income anyway. However, the loss of the annual exempt amount of £10,600 for capital gains tax is a downside of claiming the remittance basis. In practice however, the tax cost for taxpayers of losing the annual exemption is only £2,968, which is negligible in most circumstances.

A remittance basis user is liable to tax at up to 50 per cent on the remittance of foreign dividend income. This compares with the effective rate of 36.1 per cent on UK and non-UK dividend income payable by top-rate non-remittance basis users from 2011–12 onwards.

Meaning of 'remitted to the UK'

A remittance will be made if money or other property 'is brought to, or received or used in, the United Kingdom by or for the benefit of a relevant person' or 'a service is provided in the United Kingdom to or for the benefit of a relevant person'[1] and (in either case) the money or the other property or the consideration for the service is, or is derived from, the overseas income or gains.

In this context, a 'relevant person' is:

1. the individual taxpayer;
2. their spouse or civil partner;
3. minor children or grandchildren of any of the persons at (1) or (2) above;
4. a closely held company in which any of the persons listed at (1) to (3) above or (5) below is a participator; and
5. a trust on which any of the above persons is a beneficiary.

For the purposes of the legislation, a man and woman living together as if they were husband and wife are treated as spouses, and same-sex couples living together as if they were civil partners are treated as such. The definition of 'relevant person' is wide enough to cover an indirect payment to a 'relevant person'. For example, if a non-domiciliary makes a gift abroad of remittance basis income to their adult child, the gift itself is not a remittance as the child is an adult and it can therefore be brought into the UK by the child without a remittance being triggered. However, if the child uses the money to pay for their minor child's school fees, that could be regarded as a remittance by the non-domiciliary, as a 'relevant person' (a minor grandchild of the non-domiciliary) will have received a benefit in the UK.

To avoid such a situation occurring, a non-domiciliary should not use any remittance basis income or gains for funding any relevant person (or any trust for someone within that definition) if there is any likelihood that the funds or assets derived from them could be brought to or used in the UK at any time.

Temporary non-residence

Non-domiciliaries who have run out of funds capable of remittance to the UK without a tax liability may think of ceasing to be resident in the UK for a year, on the assumption that in the year of non-residence they can then remit enough money to keep going for a further period. However, where such a taxpayer has been resident in the UK for four out of the preceding seven years, and then ceases to be resident for less than five complete tax years, they will be taxed on remittances made in the years of absence, which arose while they were resident, in the year in which residence is resumed.

Income which actually arises during the years of non-residence will be capable of remittance in that (or a subsequent) year without a tax liability. However, capital gains realized in years of non-residence which are remitted will be taxable in the year of return to the UK unless the taxpayer has been non-resident for five complete tax years.

Thus if a non-domiciled taxpayer has a period of non-residence from the UK which is less than five complete tax years, the greatest care must be exercised before any remittances are made to the UK in the years of absence.

Exempt property

The legislation contains a list of exempt assets that will not constitute a remittance even if purchased abroad with remittance basis income or gains and brought into the UK. These include:

- property such as works of art, a collector's item or an antique, which is or are on public display at an approved establishment (ie a museum, gallery or other institution);
- clothing, footwear, jewellery and watches for personal use;
- assets costing less than £1,000;
- assets brought into the UK for repair and restoration; and
- assets brought into the UK for less than a nine-month period.

The legislation provides for a clawback of this relief where the exempt property is sold or otherwise converted into money while it is in the UK or otherwise ceases to be exempt property. For example if a UK resident non-domiciliary used remittance basis income or gains to buy a Rolex watch abroad, for personal use, and brings it into the UK, it is exempt from being regarded as a remittance. However, if they then sell the Rolex while it is in the UK, a remittance of the remittance basis income and gains used to purchase it occurs at that time.

Property owned on 11 March 2008

The legislation provides a form of grandfathering relief for property owned by the taxpayer on 11 March 2008, other than money, that was purchased abroad with remittance basis income or gains. Curiously, the legislation does not specifically provide for a clawback of this relief where the property is subsequently sold or converted into money while in the UK.

Non-domiciled settlors of overseas trusts

UK-domiciled and resident settlors of overseas trusts who have an interest in such trusts are taxed on the chargeable gains arising to the trustees. Such gains are treated as forming the highest part on the amount on which the settlor is chargeable to capital gains tax for the tax year. This does not apply to non-domiciliaries.

Non-domiciled beneficiaries of offshore trusts

Non-domiciled beneficiaries (including the settlor) who receive a capital distribution from an offshore trust will be subject to UK tax on capital payments received in the UK which are matched with trust gains. This charge to tax will be subject to the remittance basis where the non-UK-domiciled beneficiary is a remittance basis user. This will be the case whether the trust gains arose on UK or non-UK assets. However, capital payments received by resident non-domiciliaries which are kept out of the UK will not be taxed even if matched with UK gains.

Non-domiciled shareholders in overseas companies

Gains made by offshore closely held companies will be attributed to non-domiciled shareholders if the offshore holding is 10 per cent or more (including the shareholding of their associates). Such a shareholder claiming the remittance basis taxation will be taxed on the attributed gains of the offshore company to the extent that they are remitted into the UK.

US citizens

For non-domiciled individuals other than US citizens, the decision to pay the £30,000 (or £50,000) charge will be a simple economic choice – the question will be whether the global tax bill will be less if the benefit of the remittance basis of taxation in the UK is retained.

For non-domiciled individuals who are US persons, the question is not so simple. US persons are taxable on their worldwide income and gains, and so avoiding UK tax under the remittance basis is only beneficial to the extent that the UK effective rate of tax that would have been paid is higher than the US effective rate on that income. There is also the lingering question as to whether the payment of the £30,000 (or £50,000) will qualify as foreign tax credit on the US return. At the time of writing, the IRS has not yet reached a decision on this issue.

Planning for non-domiciliaries post April 2008

Despite changes introduced by the Finance Act 2008, there are still tax planning opportunities for non-domiciliaries. These include the following.

Bank account planning

In order to achieve the most favourable tax position in the UK for a non-domiciliary, segregation of funds so that it is clear which particular category of income or gain has been brought into the UK is absolutely key. It is very important to get this right from the outset. There is no second chance to do so. Broadly, what a non-domiciliary needs to do is to establish a clean capital account that consists of capital or income or gains generated prior to becoming UK resident and several different accounts to hold the different categories of income and capital gains arising after they become resident.

Pre-entry gain crystallizations

For non-domiciled individuals who are coming to the UK and intend to become UK resident, of paramount concern will be to ensure, so far as possible, that they crystallize any gains before coming to the UK. The proceeds of such a disposal should be deposited in a pre-entry bank account, which should not be tainted by post-entry income and gains.

Inheritance tax

So long as an individual remains non-domiciled, inheritance tax on any UK-situs assets can be easily avoided by holding those assets through an offshore holding company. This effectively converts a UK asset into a non-UK asset since one only looks at the shares of the holding company and ignores the underlying assets owned by the company itself. However, it is essential to obtain professional advice when embarking on this type of planning, especially where the asset involved is the individual's UK home.

Excluded property trusts

Where the settlor of the trust is a non-domiciled individual, and the trust assets are situated outside the UK, the settlement will be wholly excluded from the scope of inheritance tax even if the settlor subsequently becomes domiciled or deemed domiciled in the UK.

Furthermore, the trustees of an offshore excluded property trust can realize a gain without it being imputed to the resident non-domiciled settlor. This provides a good vehicle to defer capital gains, even on UK assets. However, care needs to be taken if the funds are eventually distributed to a resident non-domiciliary not claiming the remittance basis or a UK-domiciled resident, as the additional charge could cause the rate of CGT to increase to 44.8 per cent. Income is automatically attributed to the settlor of a settlor-interested trust, subject to the remittance basis of taxation.

Offshore bonds

In certain situations non-domiciliaries may find offshore bonds attractive as they enable them to roll up investments gross offshore and the non-domiciliary could

receive 5 per cent of the original investment 'tax free' as a return of capital, which could be remitted to the UK free of tax. It should be noted that the funds with which the offshore bond are bought must not be offshore income or gains. If the non-domiciliary investing in the bond holds it until such time as they leave the UK and become non-UK resident, they should be able to realize the bond free of UK income tax or capital gains tax provided they remain outside the UK for the requisite period.

Spouse or civil partner

Where both parties to a marriage or civil partnership are non-domiciled, it may be possible to arrange their affairs to ensure that only one of the couple needs to be a remittance basis user and suffer the £30,000 (or £50,000) charge.

Conclusion

Despite the changes introduced by the Finance Act 2008, the UK is still a fiscally attractive jurisdiction for non-domiciled taxpayers. However, this is a complex area and professional advice should be sought.

Notes

1 Section 809L Finance Act 2008