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NAVIGATING THE TRANSATLANTIC MINEFIELD! HOW SIGNIFICANT UK TAX CHANGES AFFECT U.S. PERSONS WITH UK CONNECTIONS

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NAVIGATING THE TRANSATLANTIC MINEFIELD!

HOW SIGNIFICANT UK TAX CHANGES AFFECT US PERSONS WITH UK CONNECTIONS

1. Introduction

The UK has been described as a "tax haven" for the well advised non-domiciliary. Since 2008, there have been significant changes in the UK tax treatment of UK resident non-domiciliaries that have made tax planning for "non-doms" a much more complex task. Nonetheless the basic premise about the UK being a tax haven for the well advised "non-dom" remains true.

The vast majority of US citizens who are resident in the UK are likely to be UK resident non-domiciled individuals ('**RNDs**') for UK tax purposes. In this paper, I shall use the term US RNDs to refer to US persons who are UK resident but not domiciled there.

2. Overview of the remittance basis of taxation and the £30,000/£50,000 charge

US RNDs are a subset of RNDs and so in order to consider the issues for US RNDs, it is first necessary to consider the post April 5th 2008 tax regime applicable to RNDs generally before I focus on the specific issues affecting US RNDs.

Application to RNDs generally

2.1 RNDs are entitled to claim the remittance basis of taxation. The remittance basis of taxation entitles the taxpayer to be subject to UK taxation on his UK source income and gains and his foreign income and gains to the extent that they are remitted to the UK. Subject to the exception referred to below, if a RND chooses not to make a claim to be taxed on the remittance basis, all of his worldwide income and gains, wherever arising and whether brought into the UK or not, will be taxed in the UK (subject to the provisions of any double tax treaty). Therefore, it is important for RNDs to decide whether or not to claim the remittance basis.

2.2 RNDs who have been resident in the UK for at least 7 out of 9 tax years will have to pay the £30,000 charge if they elect to be taxed on the remittance basis. However, the 7 out of 9 year rule is often a trap for the unwary and in an extreme case the charge could commence after just over six actual years of presence in the UK[1].

2.3 If a RND decides to claim the remittance basis for the tax year 2011/12, the claim must be made by October 31st 2012 if completing a paper tax return, or by January 31st 2013 if completing a return on-line. The RND will normally have to make a payment by January 31st 2013 of £45,000, being the £30,000 charge plus £15,000 as a payment on account for the next tax year (2012/13 in this example), assuming he anticipates that he will be UK resident in that tax year and claiming the remittance basis. During the tax year that the RND has made the claim, he or she will not be entitled to the UK personal

[1] For example, say that an individual arrives in the UK on April 1st 2009. He will be subject to the £30,000 remittance basis charge from April 6th 2015 even though he will only been in the UK for 6 years and 5 days at that point!

tax allowances[2], or the annual exemption for capital gains. It will therefore be necessary to calculate whether an election is appropriate.

2.4 RNDs will be required to "nominate" the source of unremitted foreign income or gains on which the charge will be paid. Once the source has been nominated, it will be important to ensure that none of the monies from that source are remitted to the UK, either deliberately or inadvertently. If the nominated income or gains are remitted, it might appear that no tax charge arises. However the practical reality is different; the remittance of the nominated amount will be deemed to be a remittance of the RNDs other foreign income or gains. Further, ordering rules will apply to determine what is remitted in a tax year which, it appears, will affect the present tax year and all future tax years as well. The ordering rules apply to the extent of the actual remittances of income or gains and they operate on a "worst first" basis, treating income as being remitted prior to capital gains and capital.[3]

2.5 Due to the uncertainty for the remittance basis user of the ramifications of remitting the nominated amount (in full or in part) we have recommended to our (non-US) RND clients that a separate, interest-bearing account is set up outside the UK to provide the RND with a source of income which will never be remitted. If the amount in this account is relatively small this should not create any inconvenience. All that is necessary is that the relevant account should generate some interest; £1 by the end of the tax year will be sufficient. The legislation provides that where the source of income or gains is insufficient to create a tax charge of £30,000, the charge is nonetheless increased to £30,000.

2.6 Provided the RND pays the £30,000 charge direct to HMRC from a foreign bank account (not being the nominated source), the payment will not itself be treated as a remittance.

2.7 Where more than one member of a family is potentially subject to the remittance basis charge, it will be worth considering whether the family's affairs can be restructured to limit the payment of the charge to one family member.

2.8 There are ordering rules if RNDs remit monies from mixed accounts – broadly, monies giving rise to the highest rate of tax are deemed to be remitted first. RNDs should therefore consider opening a number of different bank accounts in order to segregate different types of income (i.e. income which carries tax credits from that which does not) and the proceeds of sale of investments sold at a loss, no gain or a gain. This will enable them to choose in which order they remit monies to the UK to give themselves the most favourable tax result.

2.9 From April 6th 2010, income above £150,000 is subject to income tax at 50%. In the UK Budget 2012, the UK Chancellor announced that this rate will reduce to 45% from 6th April 2013.

Specific issues for US RNDs

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[2] In the case of taxpayers with taxable income over £112,950, the loss of personal allowances will occur anyway and so this would not be an actual cost of claiming the remittance basis.

[3] From 6th April 2012 the rules on nominated income have been simplified so that individuals are allowed to remit up to £10 of overseas income or capital gains which they have nominated for the purposes of the annual remittance basis charge without being taxed on that remittance and without being subject to the ordering rules.

2.10 Because US persons are taxable on their worldwide income and gains in the US, claiming the remittance basis in the UK will only be beneficial to the extent that the UK effective rate of tax that would have been paid on that income is higher than the US effective rate.

2.11 From the time that the £30,000 remittance basis charge was introduced in April 2008 until August 2011, there was uncertainty as to whether the IRS would permit a credit for the payment of the £30,000 against the US income tax liability of the US RND. In August 2011, the IRS issued a Revenue Ruling 2011-19 which states that the £30,000 charge can be taken as a foreign tax credit by US RNDs. This Revenue Ruling is good news for US RNDs and it may change their decision on whether to pay the remittance basis charge in the future, rather than subjecting their worldwide income and gains to UK taxation.

2.12 In addition, US RNDs who have paid the remittance basis charge of £30,000 in 2009 and 2010 and who have already filed these US returns should consider with their US/UK accountant whether these US tax returns need to be amended.

2.13 With non-US top rate taxpayer RNDs, the decision on whether to pay the £30,000 charge is based on simple maths: will the non-UK income exceed £60,000 or will the non-UK capital gains exceed £107,143? Where the RND is a US person, the issues are much more complex. The US RND must pose himself the following questions. Will the claiming of the remittance basis, factoring in the potential availability of the £30,000 remittance basis charge as a credit, result in a lower overall income tax liability for the US RND? Can he afford to fund his UK spending requirements without resort to non-UK income on which he has claimed the remittance basis? In every case, the US RND will need to sit down with his US/UK accountant in order to examine these questions.

2.14 Where a US RND taxpayer chooses to pay UK tax on his worldwide income, it might seem at first glance that the US RND taxpayer will pay the higher of the two countries' effective tax rates and that double taxation should be avoided under the treaty. If only life was so simple! Unfortunately, the US and the UK treat common forms of income and gains differently for tax purposes. Examples of this include:

- Interest earned on US municipal bonds is tax exempt in the US but is subject to income tax at 40% (or 50% depending on the taxpayer's level of other income) in the UK.

- The US rate of tax on disposals of collective investments in US mutual funds is currently 23.8%. Under UK rules such disposals are taxed as offshore income gains at the income tax rate of 40% (or 50% depending on the taxpayer's level of other income) unless the fund is a 'reporting fund'[4] for UK income tax purposes.

[4] "Reporting fund" is a new term for offshore funds from a UK perspective, the returns on which are subject to capital gains tax treatment which is currently more favourable than UK income tax rates of 50%. It replaces the term 'distributor status fund' as part of the changes to the offshore fund rules. A number of US focussed investment mangers in London provide access to US mutual funds that have obtained reporting fund status for UK purposes. Of course, as always, care needs to be taken "not to let the tax tail wag the commercial dog" but where there is a sound investment rationale for investing in a particular mutual fund in any event, the fact that it has reporting fund status is a significant attraction when compared with a fund of equal commercial outlook that does not have reporting fund status.

- Remittances of US qualifying dividends, as with remittances of all non-UK dividend income by remittance basis users, are taxed at 40% (or 50% depending on the taxpayer's level of other income) in the UK. Such dividends are taxed at an effective rate of 25% (or 36.11 % depending on the taxpayer's level of other income) in the UK in the hands of non-remittance basis users.

- In the UK, a principal private residence that is occupied as such or deemed to be occupied as such is fully exempt from UK capital gains tax. There is only a restricted $250,000 exemption available in the US.

2.15 Ultimately whether a US RND chooses to pay the £30,000 charge will depend on the nature of his/her assets and his/her sources of income. In depth calculations by US/UK specialist accountants will be needed to determine if paying the £30,000 will result in overall US/UK tax savings.

2.16 Although non-US RNDs can delay making a decision on whether to pay the £30,000 charge for the UK tax year 2011/12 until January 31st 2013, this is not so for US RNDs. In fact US RNDs may need to have made this decision as early as April 15th 2012. This is because making a claim for part or all of the £30,000 charge on a 2010 US tax return may involve "re-sourcing" (under the UK/US double tax treaty) US income as foreign income in order to claim credit for the £30,000 charge, this in turn may reduce the amount of US tax owed at April 15th 2012.

3. Overview of UK estate taxation for the US estate planner

I have set down below the key UK inheritance tax ("**IHT**") rules that the US estate planner needs to be aware of.

3.1 UK resident and domiciled individuals are subject to UK taxation on their worldwide income and gains and are subject to IHT on their worldwide assets.

3.2 US RNDs who elect for the remittance basis of taxation are subject to UK tax on their UK income and gains and on their foreign income and gains to the extent that they are remitted into the UK.

3.3 RNDs who are not deemed domiciled[5] in the UK are subject to IHT on UK situate assets only[6]. If such individuals become deemed domiciled in the UK, they will be subject to IHT on their worldwide assets.

3.4 There is an unlimited spouse/civil partner exemption from IHT subject to the fact that where assets pass from a UK domiciled or deemed domiciled spouse/civil partner to a spouse/civil partner who is not UK domiciled or deemed domiciled, there is only a

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[5] Under s267(1)(a) IHTA 1984, an individual is deemed domiciled in the UK if he has been resident in the UK for 17 out of the previous 20 UK tax years. An individual is also deemed domiciled if he has been domiciled under the general law at any time in the previous three years before a relevant event. Deemed domicile applies only for IHT purposes and for the purposes of the pre-owned assets income tax charge.

[6] Subject to possible treaty relief in a US/UK context in the case of assets other than:

- real estate; and

- business property of a permanent establishment: Articles 6 and 7 of the estate tax treaty.

limited spouse/civil partner exemption of £55,000[7] available. It was announced in the draft Finance Bill 2013 that this figure will be increased to the same level as the prevailing nil rate band (currently £325,000) from 6th April 2013. Non-UK domiciled recipient spouses/civil partners will be permitted to make an election to become UK domiciled for inheritance tax purposes so long as the UK domiciled spouse/civil partner dies on or after 6th April 2013. The election will be irrevocable, but will lapse once the surviving non-UK domiciled spouse/civil partner has been non-UK resident for three successive tax years.

3.5 Individuals who are registered as civil partners under the Civil Partnership Act 2004 are treated as spouses for UK tax purposes. Of course the US Federal authorities do not recognise civil partnerships and so civil partners are not entitled to the marital deduction for US Federal estate tax purposes. This is so even if the parties entered into a civil partnership in a state in the US that recognises them.

3.6 Where it is wished to obtain the spouse/civil partner exemption, assets must be passed to the surviving spouse/civil partner either absolutely or by giving them an *"immediate post death interest"*[8] ("**IPDI**") in the assets.

3.7 It is possible for a non-UK domiciled individual to shelter their non-UK assets from IHT by transferring them to an appropriately structured trust: an "**excluded property trust**"[9]. If this is implemented correctly then the non-UK assets in the trust will remain outside the IHT charge even if the settlor becomes domiciled in the UK[10].

3.8 The UK nil-rate band is £325,000 and is frozen until 5th April 2015, after which it will be indexed for inflation.

3.9 In the UK, it is possible to make an absolute and irrevocable gift that if structured appropriately, will avoid IHT if the donor survives the gift by seven years[11]. This is commonly known as a "**PET**" (potentially exempt transfer).

3.10 The gift of assets to any kind of trust, even a revocable[12] trust triggers an immediate lifetime IHT charge on the excess over £325,000, where the gift is within the IHT

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[7] In a US/UK context, Article 8(3) of the estate tax treaty effectively provides a greater exemption to the extent of 50% of the value of property passing to a non-UK domiciled spouse from a spouse who is a US national (but UK domiciled).

[8] Broadly an interest in possession created under a will: s49A IHTA 1984.

[9] Under s48(3) IHTA 1984.

[10] This is not necessarily the case in relation to interest in possession trusts created before March 22nd 2006 in which the settlor or his spouse had an initial life interest: s80 lHTA 1984.

[11] A potentially exempt transfer: s3A IHTA 1984. After three years the rate of tax is tapered downwards.

[12] If a trust is revocable and the proper law of the trust follows section 603 of the Uniform Trust Code, it may be possible to take a position that the "trust" is in fact a nominee arrangement for the purposes of UK tax law. Section 603 UTC provides that where a trust is revocable and the settlor has capacity to revoke the trust, the rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor. That being so, there may not in fact be a trust for the purposes of UK capital gains tax or inheritance tax. Everything will depend on the drafting and the applicable proper law. Some state statutes (e.g. California Probate Code section 15800) impose rules almost identical in effect to section 603 UTC. For further reading on this issue see *Kessler, Taxation of Non-Residents and Foreign Domiciliaries 2011-12* paragraph 72.11.

charge. Accordingly, in the case of US citizens, there are two primary ways in which they could fall into this trap:

(a) A gift into trust by a UK domiciled or deemed domiciled US citizen; or

(b) A gift into trust of UK assets by a US citizen.

3.11 This lifetime chargeable transfer on a gift into trust is a significant trap for the unwary with potentially catastrophic tax consequences and it reinforces the need to take UK advice any time that US citizens are doing anything with trusts or otherwise, where there is a UK connection.

3.12 There is a UK inheritance tax regime that is potentially applicable to UK connected trusts, known as the "**relevant property regime**". Broadly, it involves an inheritance tax charge of up to 6% on every ten year anniversary of the trust's creation and up to 6% on exits of principal. Unless anti-avoidance rules known as the "gift with reservation of benefit"[13] rules apply, where assets are in the relevant property regime they are outside the beneficiaries' estates for IHT purposes. A more detailed note on the relevant property regime is contained in the Appendix.

4. Benefits of excluded property trusts for US citizens living in the UK

4.1 The rate of IHT is 40%. An excluded property trust is a trust created by an individual who is non-domiciled in the UK and which holds non-UK assets. The benefit of an excluded property trust is that the assets are insulated from IHT on death (chargeable at a rate of 40%) even if the settlor/grantor of the trust subsequently becomes domiciled or deemed domiciled in the UK.

4.2 The question might be asked, is there any point in creating an excluded property trust for an US citizen to save 40% UK IHT if they going to have to pay US estate tax at the same rate anyway? For US citizens, the benefit of an excluded property trust is an IHT saving of 40% on the difference between the nil rate band amount in the UK and the US estate tax exempt amount. Therefore if a US citizen creates an excluded property trust (which can be, if required for US purposes, a revocable trust) it can effectively shelter their assets from UK inheritance tax even if they subsequently become domiciled or deemed domiciled in the UK. I understand that for the US tax year 2013 the estate tax exemption indexed for inflation is approximately $5.25m. Therefore, based on a £/$ exchange rate of 1.6 their inheritance tax saving on the first $5.25m would be £1,182,500. Since January 1st 2013 there is no longer an additional rate saving of 5% where UK inheritance tax is avoided. This is because both the US and UK rates are now 40%.

4.3 Another advantage of a long term UK resident US citizen having funded an excluded property trust during his lifetime is that it is not necessary to have the added complication of dealing with the US/UK treaty in relation to the assets in the trust fund on death.

5. Impact of the US/UK estate tax treaty

5.1 The 1978 UK-US Estate & Gift Tax Treaty (the "**Treaty**") is known as a "domicile treaty" in that its broad purpose, subject to some exceptions, is to give exclusive taxing rights to the country of treaty domicile. It also provides for priority of taxing rights

[13] Broadly, the UK equivalent of Section 2036 of US Tax Code.

where assets are doubly taxed and some other relieving provisions. The principal articles of the Treaty are discussed below:

5.2 Article 4 – Fiscal domicile

If an individual is domiciled in both the US and the UK under the domestic laws of each country then it is necessary to look at the fiscal domicile article of the treaty to determine where that individual is domiciled for treaty purposes. The fiscal domicile article is important as the country of treaty domicile will generally have sole taxing rights except for on Article 6 and 7 property (real estate and business property of a permanent establishment). Article 4 provides for treaty tie-break rules for dual domiciliaries as follows:

- A UK national is domiciled in the UK if not resident in the US for income tax purposes in seven out of the ten US tax years ending with the year of the transfer.
- A US national is domiciled in the US if not resident in the UK in seven out of the ten previous tax years ending with the year of the transfer.
- If a single treaty domicile under the above can not be determined then the standard OECD tie break provisions apply.

<u>Example</u>: A UK domiciliary and national leaves the UK to move to Chicago to work for an investment bank. Based on his facts, English domestic law still regards him as domiciled in the UK. After 4 years in the US, he has established ties in the US such that under the US "facts and circumstances" test he is domiciled in the US. In those circumstances, the Treaty will provide that for the first 7 years of his US residence, he is still domiciled in the UK. After 7 years, this test is no longer determinative and it is necessary to move on to the next test specified under the treaty (permanent home available and so on) to determine his fiscal domicile.

5.3 Article 5 – taxing rights

Article 5 provides that individuals domiciled in one state are not taxable on property situated in the other state other than on immoveable property and business property of a permanent establishment in that other state. However the Treaty preserves the rights of both countries to tax their nationals as though the Treaty had not come into effect.

Who is a UK national?

5.4 For these purposes we also need to consider who counts as a "national" in the UK. Article 3 of the Treaty explains that a British "national" is a citizen of the UK. Generally UK citizenship is determined by birth. If the client was born before 1983 they are likely a citizen if they were born in the UK. If they were born after 1983, they are a citizen if one of their parents was a British citizen or if one of them was legally settled in the UK.

5.5 Articles 6 and 7 - Immovable property and business property of a permanent establishment

These articles provide that in the case of immovable property and business property of a permanent establishment, the taxing rights of the country of situs is always preserved.

5.6 Article 8 – Deductions, exemptions etc.

Article 8 provides for various relieving provisions including some that can, in appropriate circumstances, reduce the UK inheritance tax on assets moving from a UK domiciled spouse to a non-UK domiciled spouse by 50%.

6. Tax consequences of UK citizenship

6.1 It should be noted that in this paper I have referred to US citizens who are '*resident'* but not*' domiciled'* in the UK. I have not referred to US citizens who are or are not also UK '*citizens'*. UK citizenship does not confer UK residence or domicile for tax purposes. It is merely one of the factors that may be taken into account in determining whether someone is domiciled in the UK.

6.2 In the UK the tax connecting factors are domicile and residence. UK domicile confers a liability to UK inheritance tax on worldwide assets. When a person is a UK resident, their domicile determines whether they are entitled to access the remittance basis of taxation. Where a person is UK resident but not domiciled he may file his tax return as a remittance basis user and only be subject to tax on UK source income and capital gains and non-UK income and gains only to the extent they are remitted to the UK. In summary, citizenship of itself does not confer a tax liability.

6.3 UK citizenship has some limited relevance for tax purposes in the circumstances described below:

Article 1(4) of the US/UK Income Tax Treaty provides:

"Notwithstanding any provision of this Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect."

This of course preserves the right of the US to tax its citizens. It does not mean that the UK taxes its citizens by reason of citizenship. The treaty says the UK "may" tax its citizens by reason of citizenship but UK domestic tax law does not do this.

It is interesting to note the contrasting wording in Article 5(1)(b) of the US/UK Estate Tax Treaty which provides as follows:

"*Sub-paragraph (a) [the paragraph that states that only the country of domicile can tax non- Immoveable Property and non- Business Property of a Permanent Establishment] shall not apply if at the time of the death or transfer the decedent or transferor was a national of that other State."*

The income tax treaty wording merely states that each State may tax its citizens, whereas Article 5(1)(b) of the Estate Tax Treaty states that the preceding relieving provision "*shall not apply*". Accordingly the US-UK Estate Tax Treaty is an example of where UK citizenship might in some circumstances confer a tax liability on an individual just because he is a UK citizen.

Example: Charles is a US citizen and domiciliary. Many years ago he worked in the UK and during that time he applied for and obtained a UK passport. He died owning shares in Tesco Plc, a UK company.

Article 5(1)(a) of the Estate Tax Treaty provides that only the country of domicile can tax the Tesco shares as they are not real estate or business property of a permanent establishment. However, Article 5(1) (b) provides that the preceding paragraph shall not apply because the decedent was also a national of the other State (the UK). Because the UK effective rate of inheritance tax is generally a lot higher than the effective US Federal estate tax rate, the acquisition of the UK passport by Charles in that situation has led to an increased tax liability for his estate. Except, of course, it would have been open to Charles to avoid this by holding his UK assets through a non UK corporation (subject to properly considering the impact of this on other US and UK taxes).

UK citizenship also has some relevance in the penultimate leg of the residence tie-breaker clause of UK tax treaties that are based on the OECD model. Articles 4(4)(c) of the US/UK Income Tax Treaty and Article 4(4)(c) of the US/UK Estate Tax Treaty provide that if the preceding articles have not determined an individual's residence or fiscal domicile respectively, then the country of nationality shall determine it.

7. The three-pronged attack on holding UK residential property through non-natural persons (which include US LLCs and other entities)

The recent changes to the UK tax treatment of UK residential property worth over £2m are discussed in an article written by one of my colleagues, Xavier Nicholas which was published in the UK's Tax Adviser in January 2013. This article is contained in Appendix 2 to this paper.

8. Statutory residence test – an update

8.1 Overview

In June 2012 HMRC published updated proposals and draft legislation for the statutory residence test, which is due to be introduced on 6 April 2013.

The latest proposals do not depart significantly from the original proposals published in June last year. Although some of the terminology has changed, the 3-part test set out in the original proposals remains essentially intact. The tests of *"conclusive non-residence"* and *"conclusive non-residence"* are now referred to as the *"automatic overseas test"* and the *"automatic residence test"*; while the third test (which determines residence according to days spent in the UK and the number of connecting factors) is referred to as the *"sufficient ties test"*. The nature of the connecting factors (or "ties"), and the relationship between the number of ties an individual has with the UK and the number of days that he can spend in the UK without being UK resident are substantially unchanged. The main developments are:

- Minor changes to the day count thresholds (increasing the number of days that an individual can spend in the UK without being UK resident by between one and five days).
- Further detail on the scope of the various definitions which appear in the test (in particular, the definitions of "work", "full-time work" and "working day"; clarification of what constitutes a "home" for the purposes of the conclusive residence test; and "accommodation" for the purposes of the connecting factors test).

As some provisions are subject to consultation, further draft legislation is expected in autumn this year and the final legislation will be published in Finance Bill 2013. This section summarises the proposals as they currently stand.

8.2 Framework for determining residence

Although the terminology does not appear in the draft legislation, a distinction continues to be made between:

- "arrivers" (individuals who were not UK resident in all of the previous 3 tax years); and
- "leavers" (individuals who were UK resident in one or more of the previous 3 tax years).

Having established whether (in relation to a given tax year) an individual is an arriver or a leaver, that individual's residence status will (as originally proposed) be determined according to which of the following 3 categories he falls into:

- conclusively non-resident (the *"automatic overseas test"*);

  or (if he is not conclusively non-resident)

- conclusively resident (the *"automatic residence test"*);

  or (if he is neither conclusively non-resident or conclusively resident)

- a combination of the number of days he spends in the UK in any given tax year and the number of "ties" he has with the UK in that tax year (the "sufficient ties test").

Because the definitions of "arriver" and "leaver" are framed in terms of residence in the previous 3 tax years, a non-UK resident who becomes UK resident will (generally) initially be treated as an arriver but will then become a leaver after 3 tax years of UK residence. Similarly, a UK resident who becomes non-UK resident will (generally) initially be treated as a leaver, but after 3 tax years of non-residence he will become treated as an arriver. As arrivers are treated more leniently than leavers, an individual wishing to become and remain non-UK resident but return to the UK to visit should be able to increase those visits once he has been non-UK resident for 3 tax years.

8.3 Leavers

(a) The automatic overseas test

A leaver will be conclusively non-UK resident in a tax year if he spends:

- no more than 15 days in the UK in that tax year; or
- no more than 90 days if he carries on full-time work abroad in the tax year (in which case he must spend no more than 20 working days in the UK in the tax year to be conclusively non-resident).

It is currently proposed that "full-time work abroad" will be defined as working in employment or self-employment abroad for an average of 35 hours or more

per week for the whole of the tax year in question, and that a "working day" will be defined as a day on which 3 hours or more is spent working. HMRC is consulting on whether to relax these rules slightly by either increasing the working day threshold to 5 hours, or increasing the 20-day limit for UK working days to 25 working days.

(b) The automatic residence test

An individual who is not conclusively non-resident under the automatic overseas test will be conclusively UK resident in a tax year if (broadly):

- he spends 183 days or more in the UK in the tax year; or
- his only home or homes are in the UK; or
- he carries on full time work in the UK.

"Home" is not defined, but HMRC has stated that it need not be a property owned by the individual. A holiday home will not count as a "home". A home that is only the individual's home for fewer than 90 days in the tax year will also not count as a home.

An individual will be treated as carrying on "full time work in the UK" if (broadly):

- he is employed or self-employed in the UK for an average of 35 hours or more per week for a period of 276 days (i.e. broadly 9 months, but HMRC is considering increasing this period to 12 months);
- all or part of the period falls within the tax year;
- there are no significant breaks from work in the period (defined as a period of 31 days or more where no more than 3 hours of work are performed in a day, excluding annual leave or sick leave); and
- more than 75% total number of working days (as defined above) are days spent working in the UK.

(c) The sufficient ties test

The residence status of an individual who is neither conclusively non-resident nor conclusively resident will depend on a combination of how many days he spends in the UK in a tax year and how many UK ties he has in that year.

The ties that apply to leavers are as follows:

Family tie	The individual has a UK resident spouse or UK resident child who is under the age of 18. There are exceptions if the individual sees his children in the UK for fewer than 61 days in the year; or if the children are in education in the UK and spend fewer than 21 days in the UK outside term time.

Accommodation tie	The individual has and makes use of accommodation in the UK. This will apply if an individual: • has a place to live in the UK (which for these purposes includes a holiday home and accommodation not owned by the individual); • that place is available for his use for a continuous period of at least 91 days in a tax year (but if there is a gap of fewer than 16 days between periods in the tax year in which a place is available for his use, that place will continue to be treated as if it were available to him during the gap); and • he spends at least one night in that place during that tax year (or at least 16 nights if the accommodation is owned by a close relative).
Work tie	The individual works in the UK for 40 or more days in the tax year in question (working days are defined as above).
90-day tie	The individual spent more than 90 days in the UK in either of the 2 tax years immediately prior to the tax year in question.
Country tie	The individual spends more days in the UK in the tax year than in any other single country.

The more UK ties that an individual has, the fewer days he will be able to spend in the UK while being non-resident:

Number of factors	**Maximum number of days without being UK resident**
0	182 days
1	120 days
2	90 days
3	45 days
4 or 5	15 days

A leaver who wishes to become non-UK resident will (generally) always have the 90-day tie in his first two years of non-residence, thereby limiting the number of days he can spend in the UK in those years to a maximum of 120 (if he has no other ties). This will continue to be the case for the third year unless he spends

no more than 90 days in the UK in the first and second years. In the fourth year of non-residence he will become treated as an arriver and should be able to increase his UK days (see below).

8.4 Arrivers

(a) The automatic overseas test

An arriver who spends no more than 45 days in the UK in a tax year will be regarded as conclusively non-resident for that year.

(b) The automatic residence test

The criteria for conclusive residence are the same for arrivers as for leavers.

(c) The sufficient ties test

Spending more time in the UK each year than in any other single country is not a connecting factor for arrivers. The other four connecting factors that apply to leavers are still relevant, but arrivers will be able to spend more days in the UK than leavers:

Number of factors	Maximum number of days without being UK resident
0 or 1	182 days
2	120 days
3	90 days
4	45 days

The 90-day tie also has potentially significant implications for arrivers: those who do not initially have the 90-day tie but who have two or fewer other ties and wish to take advantage of the higher limits of 120 days or 182 days in a tax year will have an extra tie for the following two years, thereby reducing the number of days they can spend in the UK in those years.

9. Business investment relief for investing unremitted income in qualifying UK trading companies

9.1 Summary

(a) Business investment relief ("**BIR**") came into force on 6 April 2012. The relief aims to stimulate foreign investment in UK commercial enterprises. BIR allows non-domiciled remittance basis taxpayers to potentially remit non-UK income and capital gains to the UK in order to invest in UK trading companies without triggering a tax charge.

(b) The relevant legislation is contained in s47 and Schedule 12 of the Finance Act 2012. There is no minimum or maximum level of investment required in order to qualify for the relief. However, there are certain anti-avoidance measures in place to prevent abuse.

9.2 Persons able to claim BIR

(a) BIR is available to any individual investors who are resident but neither ordinarily resident nor UK domiciled nor UK deemed domiciled and who claim the remittance basis of taxation.[14]

(b) BIR can also be claimed by persons closely connected to that remittance basis using individual. This includes their spouse/civil partner, a close company which the taxpayer is a participator and any trusts under which the taxpayer or persons connected to them are beneficiaries.[15]

9.3 Qualifying investments

(a) Nature of qualifying investments

(i) A qualifying investment must be made by way of loan finance or issue of new shares or other securities to the investor. This means that a transfer of existing shares will not qualify for the relief. However, an issue of preference shares will qualify as eligible for BIR. [16]

(ii) Any entry into a loan agreement or drawdown facility will not be eligible for the relief. Instead, each portion of the capital actually drawn down will constitute a loan for these purposes and so will be relievable as a separate investment.[17]

(iii) HMRC have confirmed that it will be possible in principle to claim BIR against foreign gains and income used to repay loans that have been taken to fund investment in qualifying companies after 6 April 2012.[18]

(b) Conditions for BIR eligibility

(i) A *"qualifying investment"* is an investment in a private trading company (including companies listed on a regulated exchange market such as PLUS or AIM) or its holding company. It also includes a private stakeholder company used to make investments in one or more private trading companies.[19]

- A *"trading company"* is one carrying on a commercial trade (i.e. acting on a commercial basis with a view to generating a profit) or preparing to do so within the next two years. [20]

- The definition of *"trading company"* includes a business carried on for generating income from land, and therefore includes the development or letting of commercial or residential property. It also includes companies engaging in

[14] s. 809B(1) ITA 2007; s. 809M(2)(a) ITA 2007
[15] ss. 809M(2)(b)-(h) ITA 2007
[16] s. 809VC(1), s.809VC(6) ITA 2007. See also HMRC guidance, para 2.11
[17] ss. 809VC(7)-(8) ITA 2007
[18] *Taxation*, 23 August 2012 p3
[19] ss. 809VD(2)-(5) ITA 2007; S809VD(11)(c) ITA 2007
[20] s.809VE(3) ITA 2007;

research and development, although not any activities that are preparatory to commencing research or development.[21]

- Investments in non-UK companies operating in the United Kingdom also qualify for the relief. However, investment in UK LLPs and partnerships cannot currently benefit from the relief.[22]

(ii) The investor or a connected person cannot receive any *"related benefits"* either directly or indirectly as a result of making the investment if they want their investment to benefit from BIR. This means that the investor or a connected person cannot receive benefits that would not be provided in the ordinary course of business at arms length or on commercial terms. For example, salary received as an investor or as a director of the company must be at commercial rates.[23]

9.4 Time limits for making a claim

(a) The relief will not be automatically granted, so an investor will need to make an express claim for BIR on the appropriate tax return. This will oblige any remittance basis users who do not usually prepare UK tax returns to do so in order to claim the relief.[24]

(b) The time limit for claiming BIR will be the first anniversary of the 31 January following the tax year in which the investment was made. For example, the deadline for filing a claim for BIR in respect of an investment made in 2012/2013 will be 31 January 2015.[25]

(c) If an investor brings funds onshore for the purpose of making an investment, they will need to make this investment within 45 days from and including the day on which the funds are brought in the UK. This is crucial as a remittance will be triggered for tax purposes once this 45 day period has expired.[26] The requirement to "make" an investment suggests that any shares subscribed for must be paid up within this period of time.

(d) Any funds that are brought onshore and are partly invested in qualifying investments will be apportioned on a "just and reasonable" basis.[27] This is likely to take place on a proportionate basis.

9.5 Termination of business and investments already claimed

(a) The relief will endure until a "potentially chargeable event" occurs. The most relevant of these events are that either the company is sold or value is extracted

[21] s.809VE(2)(b) ITA 2007; see also HMRC guidance 2.16; s207 CTA 2009
[22] s. 809VD(11) ITA 2007; see also paras 2.45 and 2.46 of HMRC's consultation response document
[23] s. 809VF(1)-(4) ITA 2007; see also HMRC guidance para 2.26
[24] See para 2.81, HMRC consultation response document
[25] s. 809VA(8) ITA 2007
[26] s. 809VA(5) ITA 2007
[27] s. 809VA(6) ITA 2007

from it by an investor i.e. a benefit is received not on ordinary commercial terms.[28]

(b) At this point the investor will either need to:

(i) reinvest the funds brought onshore into other qualifying investments;

(ii) or take the funds generated offshore again,

within 45 days of the sale and/or extraction of the value taking place. At the end of this 45 day "grace period" no remittance will be credited in respect of any funds left in the UK. [29]

(c) There are other potentially chargeable events including where the company (or its holding company) ceases to be a private trading company, where the relevant person who is making the investments ceases to be a relevant person, or where the 2 year start up rule is breached.[30] In each case mitigating action needs to be taken within the 45 day grace period in order to avoid a taxable remittance.

(d) Where the proceeds of sale exceed the amount of income or gains remitted, only the amount originally remitted needs to be taken offshore or reinvested in qualifying investments. It will also be possible to leave a set sum onshore by agreement with HMRC in order to meet any CGT liability generated.[31]

[28] s. 809VH ITA 2007
[29] ss. 809VI-809VJ ITA 2007
[30] s. 809VH ITA 2007
[31] ss. 809VI(4)-(6) ITA 2007

APPENDIX I
The UK Relevant Property Regime applicable to trusts

1. Territorial scope

Once it is established that a trust is within the inheritance tax ('**IHT**') charge either due to the UK domicile of its settlor or the UK situs of its assets, it is necessary to consider whether it is a trust that is taxed under the relevant property regime ('**RPR**') (a '**relevant property trust**').

2. A trust or settlement is a taxable entity in its own right and as such may be liable for IHT. A major change was introduced by the *Finance Act 2006*, which effectively ended the distinction between types of trust for IHT purposes, so any lifetime trust (other than a disabled person's trust) created after March 22nd 2006 is taxed under the RPR which previously applied only to discretionary trusts.

3. It is easier to set out the kind of trusts that are not relevant property trusts as all other trusts are now relevant property trusts. The trusts set down below are not relevant property trusts and are taxed under the old rules i.e. the rules applying to all interest in possession trusts before March 22nd 2006 whereby the life tenant is treated as owning the underlying assets for IHT purposes.

4. Trusts that are not relevant property trusts:

- Life interest trusts in existence on March 22nd 2006 which continue to have the same life tenant;
- New life interests carved out of pre-March 22nd 2006 life interests and created before October 6th 2008 and satisfying the conditions of s49B IHTA 1984 (known as "transitional serial interests" ('**TSIs**');
- Immediate post death interests; broadly interest in possession trusts created under a will; and
- Disabled person's trusts.

5. Any trust that does not come within the categories outlined at paragraph 4 is a relevant property trust. So, for example, any new trust created during a person's lifetime that is not a disabled person's trust is a relevant property trust.

6. Basis of charge for property held upon relevant property trusts

6.1 IHT is charged on relevant property, that is, settled property in a settlement (trust) in which there is no qualifying interest in possession (a qualifying interest in possession is one described at paragraph 4 above).

6.2 Put simply, an interest in possession ('**IIP**') means that the trustees have to pay the trust income to a beneficiary, or allow the beneficiary to have use of trust assets. The old rules continue to apply to all IIPs in existence at March 22nd 2006 and to TSIs created before October 6th 2008, therefore on death the value of the trust assets is aggregated with the beneficiary's estate and subject to IHT. This is because for IHT purposes the beneficiary is treated as the absolute owner of his interest in the trust.

6.3 The IHT rules under the RPR are briefly summarised below:

- Creation of a settlement

  On the creation of a settlement or a gift into an existing settlement during the lifetime of the settlor there is an immediate IHT charge at a rate of 20% on the value of assets transferred into the settlement over the IHT nil rate threshold (£325,000 in 2012/13 and frozen at that level for the next two years).

  Relief is available for business property and agricultural property and for normal expenditure out of income where the relevant conditions are met. Should the transferor die within seven years of the transfer into trust, the tax rate is increased to the full 40%.

- Periodic and distribution (exit) charges

  Trusts within the RPR are subject to periodic charges on every tenth anniversary of the creation of the settlement at a maximum rate of 6% of the value of the trust assets over the nil rate threshold. There is an exit charge at a maximum of 6% on the value of the capital leaving the trust over the nil-rate threshold. There is no exit charge if property leaves the settlement within three months after the creation of the settlement or within three months of a ten year anniversary charge.

APPENDIX II

Changes to the taxation of UK residential property: the calm after the storm

11 December 2012:

- Confirmation of the annual charge and extension of capital gains tax to residential properties worth over £2m owned by "non-natural persons".
- Significant exemptions for trusts, property developers and investors, public houses and farms take the sting out of the original proposals.
- A tough message for owner occupiers means restructuring before April 2013 remains necessary in some cases.

Budget 2012 and moral repugnance

The Chancellor's description in his Budget 2012 speech of aggressive tax avoidance as "morally repugnant" set the tone for the announcement of a general anti-abuse rule (**GAAR**) and a package of measures designed to pull the plug on the use of "envelopes" to hold UK residential property. The consultation paper released in May confirmed what became known as the "three pronged attack":

- A new stamp duty land tax (**SDLT**) rate of 15% on the purchase of UK residential property for over £2 million by "non-natural persons" (**NNPs**), effective from 21 March 2012.
- An annual charge, now known as the annual residential property tax (**ARPT**), on properties valued at over £2 million owned by NNPs, effective from 1 April 2013.
- The extension of capital gains tax (**CGT**) to non-UK resident NNPs on disposals of UK residential properties, effective from 6 April 2013.

The definition of NNPs for SDLT and ARPT purposes was to include companies, collective investment schemes (**CIS**), and partnerships in which a company or CIS is a partner. For CGT purposes, the definition was also to include trusts.

Consultation and confusion

While the SDLT changes were announced as a "done deal" (or so it seemed), the ARPT and CGT proposals were subject to a period of consultation.

Lobbying followed. Concerns were raised about the effects on the London property market, the City, and the wider economy. Objections were made that the extent of SDLT avoidance had been misunderstood and over-stated, the use of envelopes having been driven by inheritance tax planning and asset protection, and SDLT having more often than not been paid on the purchase by the envelope. The absence of rebasing provisions from the proposed CGT charge was criticised as retrospective. Fears were expressed that taxpayers could be penalised for "de-enveloping", as a result of tax liabilities triggered when dismantling structures.

Professional advisors, meanwhile, were busy deciding what to advise their clients. Frustratingly for many, the best advice has been to wait and see. The release of the draft legislation, then, was nervously anticipated.

Legislation and enlightenment

Many will be pleased to discover that the draft legislation contains not only significant revisions to the ARPT proposals, but also unexpected amendments to the SDLT changes implemented in March. Unfortunately, the CGT legislation will not be published until January 2013 (and the SDLT changes will not be effective until Finance Bill 2013 receives Royal Assent, probably in June or July 2013).

The full picture therefore remains to be seen, and in some cases a further wait may be necessary before decisions can be made. The following is a summary of the highlights so far.

Trusts awarded "natural person" status

The draft legislation seeks to align the SDLT and ARPT rules, and indications are that the CGT provisions will follow suit as far as possible. The proposal to treat trusts as NNPs for CGT purposes has been dropped, so a common definition of NNP will apply to all three taxes. This is a welcome simplification and should preserve the scope for planning involving direct trust ownership in appropriate cases (although the resulting IHT exposure will still need to be managed).

Open for business: exemptions from the new rules

In response partly to concerns about the impact of the new rules on inward investment, another welcome change is an exemption from the 15% SDLT rate (in favour of the standard 7% rate), ARPT and CGT, for properties held by NNPs for the following "business" purposes:

- redevelopment and resale in the course of a property development trade;
- resale in the course of a property trading business;
- rental investment;
- employee accommodation (but only for employees with less than a 5% stake in the business);
- occupation by farmworkers for the purposes of a commercial farming business;
- enjoyment by the general public on a commercial basis for at least 28 days per year; or
- charity.

The business use exemption must be claimed within 30 days of purchase and then annually by 30 April each year (although the first claim is due by 1 October 2013). Changes of use part way through a year must be reported within 90 days.

An exemption from the 15% SDLT rate for property developers with a two-year history had already been included as part of the SDLT reforms in March, and the consultation promised a similar exclusion for the ARPT. The removal of the two-year requirement, and the widening of the exemption to include rental investment and other business uses, will be warmly received. Developers should be reminded that the exemption from CGT does not necessarily mean exemption from tax: development profits are likely to be subject to either corporation tax or income tax.

No place like home: a message for owner occupiers

The business use exemptions contain traps for the unwary. In particular, the exemptions for property development, trading and investment will be disapplied if a property is occupied by a "non-qualifying person" (and, importantly, even if that person occupies on commercial terms). The definition of a "non-qualifying person" is extremely wide. It includes an individual who owns the property holding company (or who is the settlor of a trust which owns the company), the individual's spouse, his relatives, and the spouses of those relatives.

Exemption from the 15% SDLT rate is similarly conditional on the property qualifying for the business use exemption and not being occupied by a non-qualifying person for 3 years following the purchase (with a claw-back charge where these conditions are breached). One might expect restrictions along the same lines to be included in the CGT legislation.

Property valuation and the ARPT

The ARPT rates remain unchanged:

Property value	ARPT
£2m or less	No charge
£2m - £5m	£15,000
£5m - £10m	£35,000
£10m - £20m	£70,000
Over £20m	£140,000

The bands will be fixed going forward, but ARPT will be linked to the CPI. Properties will be valued on purchase and on 5-yearly valuation dates beginning on 1 April 2012, with a pre-valuation checking service for properties within 10% of a threshold. Where a property qualifies for exemption from ARPT for part of a year only, the charge will be pro-rated.

Walking the capital gains tax cliff edge

Where the business use exemption does not apply, any gain on the disposal by a NNP of a property for over £2m will be charged at the higher rate of CGT (28%). In response to comments that the £2m "cliff edge" could create distortions in the market (by creating an incentive to under-sell a property in order to avoid tax), a tapering relief will apply to reduce the effective rate on sales for just over £2m.

Rebasing conceded

The accusation of retrospective taxation has been acknowledged. On the disposal of a property by a NNP for over £2m (and if the business exemption does not apply), only the gain attributable to the period since 6 April 2013 will be subject to CGT.

UK resident companies next in line?

The government is considering whether to extend the CGT charge to UK resident companies, which would lead to an increase over the corporation tax rates that currently apply.

The view from abroad: a sigh of relief

The revised proposals will be met with a sigh of relief by non-residents and non-domiciliaries in particular. The business use exemption is a substantial concession and means that genuine "non-owner-occupiers" should not be affected by the new rules. Many well-advised UK residents will have avoided company ownership for their family homes due to existing anti-avoidance rules. Where these structures exist, both residents and non-residents should consider restructuring before April 2013. Care will be essential to avoid inadvertent CGT and SDLT charges on transfers of ownership.

So far as new purchases are concerned, for many investors the new rules will mean a return to business as usual. Non-resident companies (combined with non-resident trusts where appropriate) will continue to appeal as mechanisms which, depending on the circumstances, can be used as a shelter against inheritance tax, to mitigate income tax, and defer or avoid CGT. As before, scrupulous implementation and management will be essential to the successful navigation of anti-avoidance rules. On-going monitoring will become even more important from April 2013 as non-business use, even for a short period, could give rise to tax liabilities. To complicate things further, the impact of the GAAR will also soon require consideration.

The coalition conundrum

The recent speculation and uncertainty were no doubt partly fuelled by the fact that the consultation document released in May asked as many questions (19 in total) as it answered. The impression was not of a particularly sure-footed proposal, nor one that was released with complete conviction. It might be suggested that while the coalition government felt the need to be seen to be tough on tax avoidance, particularly in view of press attention at Budget time, the PR objective was achieved when the initial announcements were made. Subsequent amendments are more likely to fall beneath the radar of casual observers and are perhaps more readily conceded as a result.

While it would be excessive to describe the most recent announcements as a u-turn, the revisions have taken much of the force out of the original proposals. The three "prongs" have not quite fallen off, but they are certainly less sharp than they were.