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REMITTANCE BASIS CHANGES FROM 6 APRIL 2008

Individuals who are non-domiciled or not-ordinarily resident in the UK face many changes to their tax position from 6 April. New planning techniques and strategies will be required to minimise the tax cost of these changes in future years.

In the 2007 Pre-Budget Report, the Government announced changes to the residence and domicile tax rules that restrict the tax advantages available to individuals who are resident in the UK but not domiciled here. A number of relaxations to the proposals were published at Budget 2008. The new regime for 2008/09 onwards will allow non-doms to shelter UK assets in offshore trusts with tax deferral or avoidance possible

This News Release outlines our understanding of how the new tax rules could affect you. Further issues may come to light once the new legislation is implemented by the Finance Act in the summer.

Remittance Basis

Individuals who are resident, ordinarily resident and domiciled in the UK are taxable on their worldwide income and gains arising in a tax year. However, individuals who are resident but not domiciled, or not ordinarily resident, in the UK can currently claim for an alternative "remittance basis" to be applied to tax their foreign income so that it is only taxable in the UK when they remit it here in some form.

Under the draft legislation, individuals who are resident but not domiciled, or not-ordinarily resident, in the UK will still be able claim the remittance basis of taxation for foreign income and chargeable gains. However, if their unremitted foreign income and gains are less than £2,000 for a year, the remittance basis will apply automatically.

From April 2008, individuals who have a larger foreign income and claim benefit of the remittance basis for a tax year will lose their entitlement to UK personal allowances and the capital gains tax (CGT) annual exempt amount for that year. Where such individuals stay in the UK for a number of years, they can claim the remittance basis for the first seven years without a further cost. With effect from 6 April 2008, the annual £30,000 charge to use the remittance basis will apply from the start of the eighth year (where the individual has been resident in the UK for seven out of the last nine tax years). This means that if 2008/09 is the individual's eighth year of tax residence in the UK, the charge will apply immediately and for subsequent years in which the remittance basis is claimed.

It will be possible to claim the remittance basis for some years but not others, for example where overseas income fluctuates. However, if overseas income is built up by a non-domiciled individual during years in which the remittance basis is claimed and then that income is brought into the UK in a year for which it is not claimed, a tax liability will arise on the income.

HMRC has stated that it will not regard a decision not to claim the remittance basis in a particular year as evidence of a change of domicile under general law.

UK resident non-UK domiciliaries who have unremitted foreign income and gains of more than £2,000 for a year and do not claim the remittance basis, will be subject to UK tax on their worldwide income and gains (and potentially, income and gains attributed to them under UK principles from certain trust and company structures).

What is a remittance?

The draft legislation significantly broadens the definition of a remittance, so much so that virtually any funds or assets brought into the UK by non-domiciled individuals will need to be considered. For example, the value of any service provided in the UK that is financed in any way “directly or indirectly” from overseas assets is likely to be treated as a remittance.

There will be exemptions for personal effects such as watches, jewellery, clothes and shoes; assets costing less than £1,000; and assets brought into the UK for repair or restoration for less than a nine month period. Where works of art are imported into the UK (either temporarily or permanently) and then put on public display, no tax charge will arise.

Any asset purchased out of untaxed foreign investment income owned on 11 March 2008 will be exempt from a charge under the remittance basis (even if it is currently outside the UK and is later imported). An asset that is in the UK on 5 April 2008 will also be exempt from the remittance basis charge, even where it is later exported and re-imported. However, bringing a physical asset (a car or antique) into the UK after 5 April 2008 that was originally acquired using overseas income will be taxed as a remittance.

Extensive tracking rules are proposed to match remittances from mixed funds (for example, a bank account containing cash that represents past investment income and gains and earnings) with each original source in a strict order. These rules allow matching from income and gains in past years. As drafted, they would have a retrospective impact and, in some circumstances, unremitted foreign income earned many years ago may fall to be matched with remittances made after 6 April 2008.

Income can be matched even where the original

source of the income has ceased and that income has been used as the “capital” of a new bank account or to buy a new asset. It is currently unclear how far back such tracking is to be taken.

A long established remittance technique for families has relied on disconnecting overseas income from a non-UK domiciled (or not-ordinarily resident) individual. If that individual makes a gift of foreign income or assets to a third party – for example, an offshore company or a relative – it was possible to “alienate” the income. Provided the individual surrenders his or her rights to the income which has been received abroad, and this income is then received in the UK by the third party without it being of any benefit to the non-UK domiciled (or not-ordinarily resident) individual, then this is not a remittance by the individual.

From 6 April 2008, where an individual makes such a gift and they or their immediate family benefit in any way, then the remittance basis of taxation will apply. The definition of ‘immediate family’ is to include spouses, civil partners, individuals living together as spouses or civil partners and their children or grandchildren under the age of 18.

Another long established practice is for non-UK domiciliaries to purchase a UK property using a foreign, interest-only, mortgage and to pay the interest from untaxed foreign income, without causing a remittance to the UK. For loans in existence on 12 March 2008, this treatment will continue so long as there is no change to the terms of the loan. If there is a further advance or a new offshore loan used to purchase UK assets, payments of interest from offshore funds will be treated as a remittance after 6 April 2008.

£30,000 Remittance Charge

A number of issues on how the £30,000 charge will operate have now been clarified.

The charge will only apply to adults – taking effect from the tax year in which the individual reaches age 18.

The charge is now to be defined as a charge on unremitted foreign income and gains and not, as originally stated, a stand-alone charge “which will be payable as though it is an income tax.” In practice, this means that the £30,000 fee can be offset against income tax or CGT liabilities arising when funds are later brought into the UK – potentially covering UK tax liabilities on up to £75,000 of overseas income.

However, this does not operate in a straightforward way. New ordering rules are to be introduced to deem that unremitted funds on which the £30,000 has not been paid are remitted before the funds on which it has been paid. For example, a non-UK domiciled individual who pays the charge has a total of £200,000 foreign income for 2008/09. As a higher rate taxpayer, if he remits £100,000 of this to the UK he will have a tax liability of £40,000 to pay in addition to the £30,000 charge. However, if he remits all £200,000 to the UK his additional liability will only be £50,000 as the £30,000 charge will cover the balance of higher rate tax on the final part of the foreign income remitted.

Therefore, to claim full tax credit in the UK for the £30,000 payment, it is likely that all overseas income and gains will have to be remitted to the UK. However, taxpayers can choose which unremitted funds the charge is to be set against so the charge paid will be either income tax or CGT and, consequently, it will also be available to cover Gift Aid donations.

This complex position arises because the Government wishes to help US nationals claim the £30,000 payment as a credit against their US tax bills. To achieve this, the payment has to be creditable as “tax”. However, the current proposals do the bare minimum and it is by no

means certain that double tax relief will be available to US nationals. For other nationals, the £30,000 charge will effectively remain a standalone fee in most circumstances.

Even with the increased likelihood of obtaining a US tax credit, UK resident US citizens will need to review in detail the extent to which they would benefit from that credit. For example, timing differences will mean that a US national will have to pay his UK tax liabilities before obtaining full credit in the USA.

HMRC has now confirmed that funds brought into the UK to pay the £30,000 charge will not themselves be subject to UK tax, provided the payment is made direct to HMRC (by electronic transfer or cheque drawn on a foreign bank account). However, if the funds are first paid into the individual’s UK bank account (or to any other UK source) before being transmitted to HMRC, then the £30,000 will be treated as a remittance.

Overseas Earnings

There are many changes affecting overseas earnings of non-domiciled individuals. For example, individuals who are not domiciled in the UK and work for international employers often have separate or “dual” contracts for their UK employment and their overseas work so that the salary for overseas work does not need to be brought into the UK. In the future, such contracts will only be tax-effective if the individual claims the benefit of the remittance basis and pays the £30,000 fee.

Offshore Income Gains

Unless an offshore fund has been certified by HMRC as having ‘distributor status,’ the gain made on a disposal of the asset is taxable as income – an ‘offshore income gain’. The remittance basis will apply to offshore income gains and, while there is complex anti-avoidance legislation to identify whether they will fall under

the income or CGT rules, all offshore income gains will be taxed at 40%.

Offshore Companies

Non-UK domiciled individuals who own offshore companies will be subject to UK tax on income or gains from UK investments made by the company in the year the income arises or gains are made from 2008/09 onwards. Income from foreign assets and disposals of foreign assets by the company or trust will be subject to the remittance basis.

With effect from 6 April 2008, gains made by offshore companies will be attributed to UK resident non-UK domiciliaries with 10% or larger shareholdings and taxed in the year the gain arises. The only exception will be where the shares in the foreign company are held by offshore trustees, in which case, the gains on UK and foreign assets will be taxed on the remittance basis.

Capital gains realised by a foreign company prior to 6 April 2008 will not be taxed on non-UK domiciled shareholders.

Offshore Trusts

The rules proposed in the Finance Bill are a major concession to the Government's original proposals. Nevertheless, there are many issues for trustees to consider to ensure that beneficiaries of offshore trusts can enjoy the tax advantages still available. The key issues are outlined below.

A non-UK domiciled settlor will not pay tax on trust gains (including gains on UK assets held by the trustees) unless or until he or she receives a capital payment in the UK from the trust and the payment can be matched with trust gains.

A non-domiciled beneficiary (including the settlor) will pay tax on capital payments received in the UK which are matched with trust gains. Capital

payments retained outside the UK will not be taxed, even if matched with UK gains.

The Government has announced it does not intend to tax offshore trust gains realised or accrued prior to 6 April 2008 where the beneficiary is not domiciled in the UK. This will lead to a number of complexities and require advisers to track pools of pre- and post- 5 April 2008 gains and capital payments, and where a rebasing election is made, pools of notional pre- and post-5 April 2008 gains. However, despite the abolition of CGT taper relief from 6 April 2008, it is the net gains after taper relief that are to be carried forward to match with future payments in such cases.

A capital payment made before 6 April 2008 will not be subject to UK CGT if it is wholly matched with pre-6 April 2008 gains or the beneficiary remains non-UK domiciled at the time the later matching takes place. A post-5 April 2008 capital payment made to a non-UK domiciled beneficiary will first be matched against current gains (i.e. those arising after 5 April 2008) and taxed if remitted to the UK. Any balance of the payment will then be matched against pre-6 April 2008 gains and not trigger a tax charge. Therefore, over time, it will become more difficult to match pre-6 April 2008 gains to avoid a CGT charge.

Capital payment matching rules – LIFO

Capital payments to all beneficiaries made on or after 6 April 2008:

- will be matched with trust gains of the current year first
- any balance is then matched with gains of previous years (going back year by year until the whole payment is matched).

Where a series of capital payments have been made:

- current year capital payments will be matched with trust gains first

- then capital payments of previous years are matched with trust gains (going back year by year until all have been matched)

Supplemental charge

Where there is a delay between a trust gain being realised and being matched with a capital payment to a beneficiary, a supplemental tax charge arises. The charge is 10% of the tax that would have been paid for each year of delay - up to a maximum of 6 years. With the rate of CGT at 18%, the maximum rate of tax with the full supplemental charge will become 28.8%.

Rebasing

Trustees of non-UK trusts will be able to make a one-time election to treat all assets held by the trust (or held by an underlying company owned by the trust) as if they had been sold and reacquired at market value on 6 April 2008, effectively removing any gain accrued prior to that date. The election must be made on or before 31 January following the tax year during which a capital payment is made to a UK resident beneficiary or part of the trust fund is transferred to a new trust.

Again, this will work on a pooling system with the gain on the eventual sale of the trust assets split between a pre-6 April 2008 pool and a post-5 April 2008 pool. Non-UK domiciled beneficiaries will not pay tax on payments matched with gains in the pre-6 April 2008 pool.

Temporary Visitors

Along with the domicile changes, new rules on tax residence have been published. From 2008/09, HMRC will be counting the number of midnights that a visitor spends in the UK as days towards the statutory 183 day residence test (and the non-statutory 91 day test).

Transit passengers, passing through UK Customs to get connecting transport, will not be regarded as having spent a day in the UK for this purpose

even if they are in the UK at midnight. However, if work is performed in the UK (e.g. a business meeting takes place) or a family visit is made, a midnight spent in the UK between transport connections will count as a day in the UK.

What to do?

The draft legislation is to be put before Parliament in the 2008 Finance Bill and there will yet be a number of changes arising from the ongoing consultations between HMRC and the professional institutes.

However, the new rules will take effect from 6 April 2008 and non-domiciled or not-ordinarily resident individuals and their families should now review their financial arrangements so that potential future tax liabilities can be identified and remedial action planned in advance.

As fundamental changes to asset holding arrangements may be required, any review should consider your long term intentions and objectives so that future investment and tax strategies can be tailored to your expected income and capital needs.

Contact

We will be contacting clients in the next few days to discuss these changes, however in the meantime please contact your Client Engagement Director on +44 (0) 1481 737600.

Praxis Fiduciaries Limited

PO Box 296
Sarnia House, Le Truchot
St Peter Port, Guernsey
GY1 4NA

Tel: +44 (0) 1481 737600
Fax: +44 (0) 1481 710511
Email: info@praxisfiduciaries.com
www.praxisfiduciaries.com