FORSTERS

DATED 21 JULY 2015

TAXATION OF UK RESIDENT NON-DOMICILIARIES

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TAXATION OF UK RESIDENT NON-DOMICILIARIES

This memorandum provides an overview of the UK tax treatment of UK resident non-domiciliaries under the remittance basis of taxation. Despite significant changes to the rules in Finance Act 2008, the UK remains a fiscally attractive jurisdiction for well advised non-domiciled individuals.

1. **OVERVIEW**

UK resident and domiciled individuals are subject to UK income tax and capital gains tax ("**CGT**") on their worldwide income and gains and UK inheritance tax ("**IHT**") 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:

1.1 Access to the "remittance basis of taxation" on foreign income and gains (albeit subject to the payment of a substantial charge in the case of long term residents – this is discussed further below);

1.2 Non-application of some of the CGT offshore anti-avoidance legislation; and

1.3 IHT on UK assets only, coupled with the possibility of insulating almost all assets from IHT even where the non-domiciled individual subsequently becomes UK domiciled or deemed domiciled.

2. **SUMMER BUDGET 2015**

In the UK Summer Budget on 8 July 2015 (the "**Summer Budget**") some significant changes were announced to the rules governing the taxation of UK resident non-domiciliaries. The new measures which are due to take effect from 6 April 2017 include the following:

- Non-UK domiciled individuals who have been UK resident for 15 out of the previous 20 UK tax years will become deemed domiciled in the UK for all tax purposes: that is they will become liable to UK income tax and CGT on their worldwide personal income and gains and they will become liable to IHT on their worldwide personal assets;

- Non-UK domiciled individuals who have set up offshore trusts before they become deemed domiciled under the new 15 year rule will not be taxed on trust income[1] and gains that are retained in the trust and the IHT excluded property status of such

[1] Curiously this represents an improvement on the current position for a UK resident non-domiciled settlor of a non-UK resident offshore trust, whereby if he was not an remittance basis user he would be liable to tax on the trust income on an arising basis. The Summer Budget announcement indicates he will not be taxable at all on income that remains in the trust. It remains to be seen whether the actual legislation is as benign to offshore trusts as the Summer Budget announcement suggests.

trusts will be retained (except to the extent they contain UK residential property – see below);

- Individuals with a UK domicile of origin will be unable to take advantage of a subsequently acquired foreign domicile at any time when they are UK resident, irrespective of the number of years they spend here; and

- Non-UK domiciled individuals will no longer be able to shelter UK residential property from IHT by holding it through an offshore company or other offshore vehicle. This will apply to property held through companies owned by both individuals and trustees.

3. WHAT IS THE DIFFERENCE BETWEEN RESIDENCE AND DOMICILE?

3.1 Domicile

Domicile must not be confused with nationality. In general terms, a person may be said to be domiciled in the place where he or she has made his or her 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. Generally speaking, an individual is domiciled in the country with which he or she is most closely connected (which may be different from the country in which he or she is resident for the time being). 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.

3.2 Residence

Since April 2013, UK residence has been determined based on a statutory test. To describe the test in detail is beyond the scope of this memorandum. Broadly, it provides for certain circumstances where a person will automatically be considered UK resident (i.e. where he has his only home in the UK, where he works full time in the UK or where he spends 183 days or more in the UK in a tax year) and other circumstances where he will automatically be considered non-UK resident (i.e. where he carries out full time work abroad, or only spends a very limited number of days in the UK in the tax year). If a person does not fall within any of these automatic tests, his status will be determined by the "sufficient ties" test. The test considers how many of five specified ties the individual has to the UK and, depending on the number of those ties, dictates how many days that individual can spend in the UK that year without becoming resident.

4. 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 remittance basis charge, if applicable (see further below). Where a non-domiciliary has elected to be a remittance basis user he is subject to UK taxation on his UK income and gains and on his foreign income and gains to the extent that they are remitted (i.e. 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, he will pay income tax and CGT on an arising basis in the UK on his worldwide income and gains.

5. THE REMITTANCE BASIS CHARGE – WHAT IS IT AND WHEN MUST IT BE PAID?

This is an annual tax charge 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 amount of the charge will depend on how long the taxpayer has been resident in the UK. It was announced in the Summer Budget that after 6 April 2017 the conditions for accessing the remittance basis of taxation will change.

Up to 6 April 2017	
Period of UK residence	**Annual charge**
Fewer than 7 out of the previous 9 tax years	nil
7 out of the previous 9 tax years	£30,000
12 out of the previous 14 tax years	£60,000
17 out of the previous 20 tax years	£90,000

On and after 6 April 2017	
Period of UK residence	**Annual charge**
Fewer than 7 out of the previous 9 tax years	nil
7 out of the previous 9 tax years	£30,000
12 out of the previous 14 tax years	£60,000
15 out of the previous 20 tax years	Not applicable - as deemed UK domiciled for all tax purposes

As the claim to be a remittance basis user is made on an annual basis, it allows a person to consider his overall income and gains position in a particular year and decide whether it will "cost" him more to be taxed on the arising basis of taxation or to pay the charge and be taxed on the remittance basis of taxation. This potentially leaves scope for planning (depending on the assets and income streams involved) to ensure that the charge is paid only intermittently, with income or gains concentrated in those years and the arising basis of taxation applicable in between.

From 6 April 2017, those who have been resident in the UK for more than 15 out of the past 20 tax years will be treated as deemed UK domiciled for all tax purposes and the remittance basis of taxation will not be available to them. The £90,000 remittance basis charge (currently payable after 17 out of 20 years of residence) will therefore be redundant. Deemed domicile status will be lost after a period of non-residence of 5 tax years.

Returning non-doms (those with a UK domicile of origin)

In relation to 'returning non-domiciliaries' it was announced in the Summer Budget that from 6 April 2017 it will not be possible for those with a UK domicile of origin at birth to establish a domicile of choice elsewhere and then claim the remittance basis on their return to reside in the UK. Such taxpayers will revert to having a UK domicile (for all tax purposes) on their resumed residence in the UK and any trusts set up during their period of non-domicile will not benefit from favourable tax treatment on their return. This will affect 'returning non-domiciliaries' from 6 April 2017 regardless of when they returned to the UK.

The Appendix to this memorandum contains a chart (prepared by HMRC) which sets out whether the taxpayer needs to pay the remittance basis charge. This is based on the position in March 2015[2] and has not yet been updated by HMRC following the two budgets in 2015.

The remittance basis charge needs to be paid when the non-domiciliary is filing their UK tax return (i.e. by 31 January following the end of the tax year for which the return is being made).

The mechanics of the remittance basis charge require the remittance basis user to nominate a portion of his income or gains that is deemed to bear the remittance basis charge. The remittance basis charge then effectively represents income tax, CGT 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 remittance basis charge has been paid. A planning point here may be

[2] HMRC have not yet published a chart that takes account of the 2015/16 changes. The chart contained in the Appendix remains correct for new arrivers to the UK.

to keep a separately identifiable portion of income, chosen to bear the remittance basis charge, in a separate account and never remit it.

As the remittance basis charge will be classified as either income tax or CGT, 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 other countries on the same income.

The remittance of 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.

6. OTHER 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 his income tax liability; nor will he be entitled to the annual exempt amount for CGT (£11,100 for 2015/16). This does not apply to individuals whose unremitted foreign income and gains is less than £2,000.

In practice, for those earning UK taxable income of more than £120,000 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 £11,100 for CGT is a downside of claiming the remittance basis. In practice however, the tax cost for taxpayers of losing the CGT annual exemption is only £3,108, which is negligible in most circumstances.

A remittance basis user is liable to tax at up to 45% on the remittance of foreign dividend income. This compares to the effective rate of 30.6% on UK and non-UK dividend income payable by top rate non-remittance basis users.[3]

7. 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"[4] 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.

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3 This reflects the position up until 6 April 2016. The Summer Budget announced changes so that from 6 April 2016, the taxation of dividends for non-remittance basis users is as follows:

Every individual will have a £5,000 tax-free dividend allowance. The old notional 10% tax credit will be abolished. Dividend income in excess of the tax-free allowance will be taxed at the following rates:

7.5% (basic rate taxpayers);
32.5% (higher rate taxpayers); and
38.1% (additional rate taxpayers).

4 Section 809L Finance Act 2008

In this context, a "relevant person" is:

(a) the individual taxpayer;

(b) his/her spouse or civil partner;

(c) minor children or grandchildren of any of the persons at (a) or (b) above;

(d) a closely held company in which any of the persons listed at (a) to (c) above or (e) below is a participator; and

(e) a trust of 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 or same sex spouses 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 his 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 his minor child's school fees that could potentially 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.

8. 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 unremitted income 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 calendar years[5], he will be taxed on remittances made in the years of absence, which arose while he was resident, in the year in which residence is resumed.

Most 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 realised in years of non-residence which are remitted will be taxable in the year of return to

[5] In the absence of split year treatment or relief under a double taxation treaty, this can require a person to be non-resident for six full <u>tax</u> years.

the UK unless the taxpayer has been non-resident for five complete calendar years. In addition, specified "high risk" categories of income are subject to the same anti-avoidance rule as apply to capital gains. These income categories are typically where the taxpayer can manipulate the timing of the income event, such as:

- dividends from closely held companies;
- receipts from offshore life policies; and
- certain pension payments.

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.

9. 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:

(a) property such as works of art, a collector’s item or an antique, which is on public display at an approved establishment (i.e. a museum, gallery or other institution);

(b) clothing, footwear, jewellery and watches for personal use;

(c) assets costing less than £1,000;

(d) assets brought into the UK for repair and restoration; and

(e) assets brought into the UK for less than a nine month period.

The legislation provides for a claw-back 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 he then sells 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.

10. 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 25% or more (including the shareholding of his or her associates). Such a shareholder claiming the remittance basis of taxation will be taxed on the attributed gains of the offshore company to the extent that they are remitted into the UK. It does not apply where it can be shown that neither UK CGT or corporation tax avoidance was one of the purposes of using the overseas company.

11. OWNERSHIP OF UK RESIDENTIAL PROPERTY AFTER APRIL 2017

As indicated at paragraph 2, it was announced in the Summer Budget that there are proposals to amend the rules on excluded property so that trusts or individuals owning UK residential property through an offshore company, partnership or other opaque vehicle will pay IHT on that property in the same way as a UK-domiciled individual. It is intended that this change will be effective from 6 April 2017.

12. US CITIZENS

For non-domiciled individuals other than US citizens, the decision to pay the remittance basis 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. In August 2011, the IRS issued a Revenue Ruling which confirmed that the remittance basis charge can be allowed as a foreign tax credit for US taxpayers who elect to be taxed on the remittance basis.

13. PLANNING FOR NON-DOMICILIARIES

Despite changes introduced by the Finance Act 2008 and the Summer Budget 2015, there are still tax planning opportunities for non-domiciliaries. These include:

13.1 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 he becomes resident.

13.2 Pre-entry gain crystallisations

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 crystallise any gains before coming to the UK (if they can do so without triggering an unacceptable level of tax in their home country). 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.

13.3 IHT– situs blocking

So long as an individual remains non-domiciled, IHT on almost 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. In fact as can be seen from paragraph 11, it will no longer be possible to use non-UK incorporated companies to situs block UK residential property after 5 April 2017.

13.4 Offshore excluded property trusts

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

Furthermore, the trustees of an offshore excluded property trust can realise a gain without it being automatically imputed to the resident non-domiciled settlor. This provides a good vehicle to defer capital gains, even on UK assets including UK real property (other than residential property). However, care needs to be taken if the funds are eventually distributed to a UK 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%. Income is automatically attributed to the settlor of a settlor interested trust, subject to the remittance basis of taxation.

Also, as indicated at paragraph 2, the Summer Budget announcements indicate that income retained in offshore trusts will not be taxed until distribution. We will need to see the detail of this legislation when it comes out in order to establish precisely what planning opportunities it presents.

13.5 Loan trust

A "loan trust" is a variation of an excluded property trust, which allows active investment of the taxpayer's clean capital while allowing tax-free loan repayments to him.

13.6 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% 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 he leaves the UK and becomes non-UK resident, he should be able to realise the bond free of UK income tax or CGT provided he remains outside the UK for the requisite period.

13.7 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 remittance basis charge.

13.8 Exemption for commercial investments in UK businesses

Business investment relief (**"BIR"**) was introduced in 2012, with the aim of stimulating foreign investment in UK trading businesses. Where the conditions for the relief are met, BIR allows remittance basis users (or other relevant persons) to use unremitted income and gains to invest in UK trading companies without triggering a taxable remittance. The investment can be made by way of loan or subscription for shares or securities. Unusually, for the purposes of BIR, "trading" includes investment in rental properties, as well as research and development from which it is intended that a commercial trade will be derived.

There is no minimum or maximum level of investment, but there are certain conditions and anti-avoidance provisions that are important to bear in mind when considering taking advantage of the relief. In particular, when the qualifying investment is sold, the sale proceeds must be taken out of the UK or re-invested in another qualifying investment within 45 days to avoid triggering a remittance.

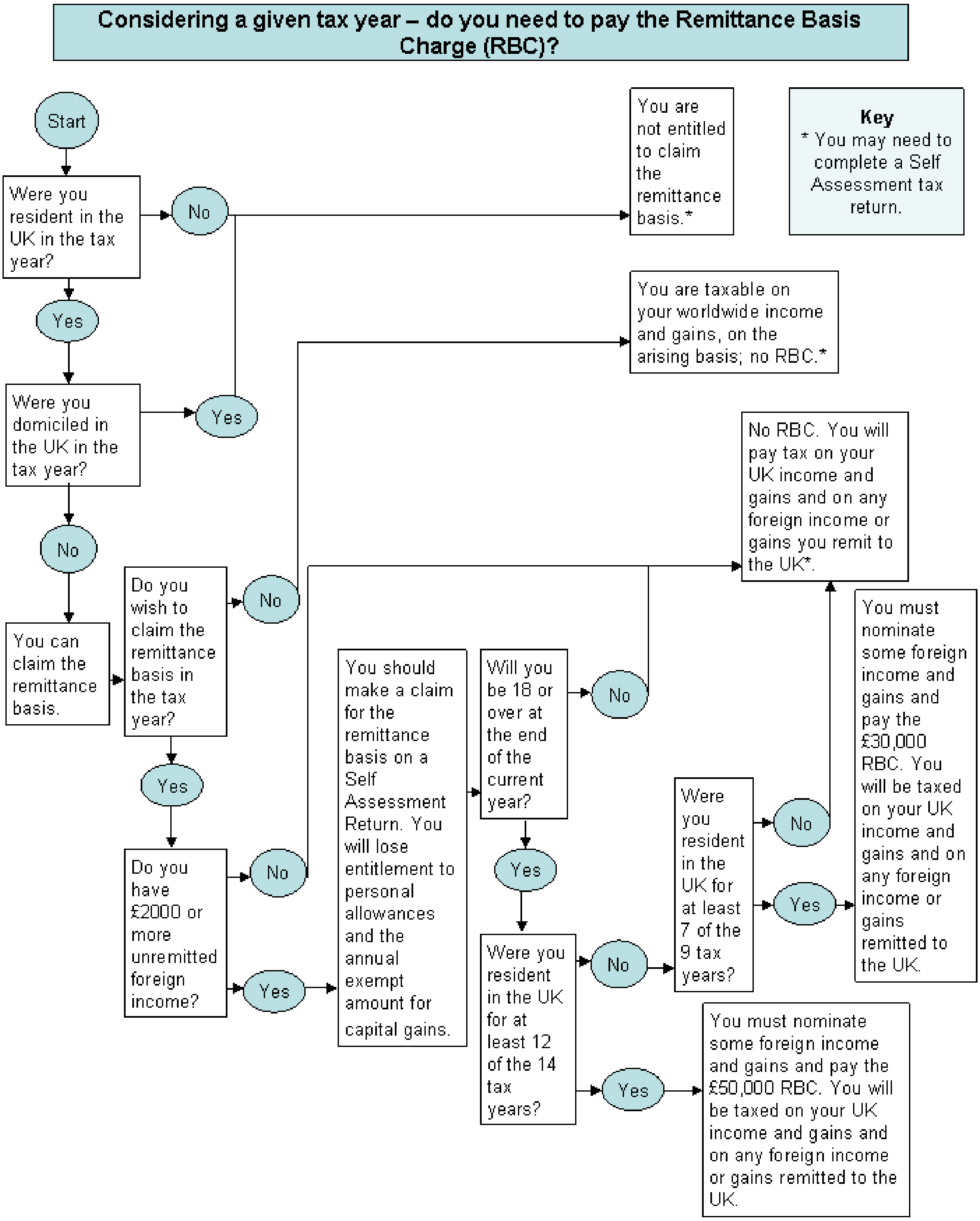
14. **CONCLUSION**

Despite the changes introduced by the Finance Act 2008 and the Summer Budget 2015, the UK is still a fiscally attractive jurisdiction for well advised non-domiciled taxpayers. However, this is a complex area and professional advice should be sought.

Forsters LLP
21 July 2015

APPENDIX 1

The latest published HMRC chart – now partially out of date but still correct for newly arriving non-domiciliaries



(**Source:** HM Revenue & Customs Guidance Note: Residence, Domicile and the Remittance Basis (published October 2013))