

Stop Press - New rules for non-domiciled UK residents - Further food for thought?

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Draft legislation to implement the changes announced in the Pre-Budget Report on 9 October 2007 has now been published. The draft legislation contains proposals which are far more wide-ranging than the Pre-Budget Report had suggested and, as a result, non-domiciled UK residents (and UK residents who are not ordinarily resident) and the trustees of trusts in which they have interests urgently need to consider whether action needs to be taken before 6 April this year.

The principal proposed changes relate to:

- the taxation of gains realised by offshore trusts and structures;
- the introduction of the £30,000 'fee' for certain non-domiciliaries resident in the UK for seven years who wish to continue to be taxed on the remittance basis; and
- other aspects of the operation of the remittance basis of taxation.

Implications for offshore trusts

Offshore trustees themselves do not generally pay capital gains tax in the UK. Historically, two anti-avoidance provisions have applied in order to levy capital gains tax upon certain settlors/beneficiaries of offshore trusts. Neither of these provisions currently gives rise to tax where the settlor and/or beneficiary in question is not domiciled in the UK. Therefore, in many cases, offshore trusts simply do not (under today's rules) generate UK capital gains tax liabilities.

Under the proposed new regime, which is due to apply from 6 April 2008, the position will be very different.

It had been anticipated that the anti-avoidance rules would be changed so that UK resident non-domiciled settlors and beneficiaries would no longer escape capital gains tax altogether; rather, the remittance basis would apply to those settlors and beneficiaries in future in respect of trust gains.

In relation to UK resident non-domiciled settlors (where the settlor or family members can benefit from the trust), the new rules are as anticipated, giving rise to a tax charge in the hands of the settlor on UK trust gains as they arise and on foreign gains only to the extent they are brought into the UK. However, the proposed new rules go far beyond what was expected in how they will apply to beneficiaries (including the settlor). They seek to levy capital gains tax charges on beneficiaries receiving capital distributions or benefits from an offshore trust **whether or not** they are non-UK domiciled and claim the benefit of the remittance basis **and whether or not** the benefit is received in the UK.

The result is that a capital gains tax liability may arise in the following circumstances:-

- a capital distribution or other capital benefit is received after 5 April 2008 where the trust has realised gains in the past or does so in future; and
- a UK resident non-domiciled beneficiary has already received a capital distribution or other capital benefit at a time when it was thought to be tax-free in his hands, and the trust realises gains after 5 April 2008.

It should also be noted that, going forward, gains made by trustees of a settlement with a UK resident non-domiciled settlor will only fall out of account for the purposes of being charged on beneficiaries who receive capital payments or capital benefits if the settlor has in fact paid tax on them.

Is urgent action required?

It is critical that the complex issues raised by the draft legislation are addressed before 6 April 2008, for example where:-

- a non-domiciled beneficiary has received a capital benefit from the trust in the past. Consideration should be given to whether the benefit has already been wholly matched against trust gains and, if not, whether gains should be realised before 6 April 2008 to ensure that such distributions have been fully matched to prevent post 5 April gains from turning the earlier distribution into a taxable event;
- the trust has realised gains which have not been matched against capital benefits provided to beneficiaries. Consideration should be given to whether distributions should be made now to 'wash out' realised trust gains and put capital in the hands of beneficiaries

without generating current or future capital gains tax charges.

In some circumstances it may be worth looking at whether a trust should be wound up altogether before 6 April 2008.

Trusts are used for many purposes, including succession planning, and although there are other tax benefits in holding assets in trusts, such as protection against UK inheritance tax, the impact of the proposed changes should be considered in relation to all affected offshore trusts.

Time is short

One of the greatest difficulties facing settlors and trustees will be that of timing. It is proposed that these rules will come into force on 6 April this year leaving only a matter of weeks in which to review the position and decide whether or not to carry out any pre-April planning. Such planning is likely to necessitate a mixture of legal and trust advice and accounting input (for example quantifying the current trust gain pool and the percentage of previous capital distributions that have already been matched with trust gains). This means legal advice should be sought now and accounting information gathered, even though the legislation is only in draft form and may change before (or even after!) 6 April.

Offshore companies

It is also worth noting that the existing provision that treats gains made through closely-held offshore companies as taxable in the hands of UK resident and domiciled shareholders holding a greater than 10% interest will also, from 6 April this year, apply to UK resident non-domiciled shareholders where either the underlying assets are situated in the UK or there is a remittance of non-UK gains to the UK. A similar provision applies to offshore trusts with underlying holding companies and where gains are made by the companies these will be treated as if they had been made by the trustees and taxed on the settlors or beneficiaries under the new rules.

New reporting requirements for offshore trusts

From 6 April 2008 there will be an extension of the existing reporting requirements for offshore trusts.

Trusts established on or after 6 April 2008

From 6 April 2008, the establishment of any new offshore trust by a person resident or ordinarily resident in the UK (regardless of domicile) will have to be reported to HMRC within three months of the date on which it was created.

When a trust is created prior to an individual becoming resident or ordinarily resident in the UK, it will have to be reported to HMRC within 12 months of the settlor becoming resident or ordinarily resident in the UK (regardless of domicile).

Transitional rules for existing trusts

There will be transitional rules so that trusts created between 19 March 1991 and 5 April 2008 by non-UK domiciled individuals currently resident or ordinarily resident in the UK will also have to be reported to HMRC by 6 April 2009.

Any existing trusts established by non-UK domiciled individuals who become UK resident or ordinarily resident after 5 April 2008 will also have to be reported to HMRC within 12 months of that individual's arrival in the UK.

These rules represent a significant extension of HMRC's information gathering powers and require reporting regardless of whether or not a liability to UK tax exists. In particular, the obligation to disclose the establishment of a trust which occurred many years before an individual's arrival in the UK and where there may be no UK resident beneficiaries seems disproportionate.

To the internationally wealthy who happily contribute to the UK economy but prize their confidentiality above all else, having to provide details of their holding structures will be another reason to avoid or give up UK residence.

The £30,000 fee

The draft legislation confirms that the £30,000 'fee' will be chargeable if individuals, who are resident in a particular tax year and who have also been UK resident during seven out of the nine years preceding that tax year, elect to continue to be taxed on the remittance basis. It appears that the year count will be calculated on a similar basis as for inheritance tax 'deemed domicile' purposes so that those that arrived in the UK in March 2002 will be caught from 6 April 2008. If the fee is paid and the remittance basis claimed, the individual's offshore income and gains will escape tax as is currently the case, unless the income/gains are brought into the UK. Individuals can elect in and out of the remittance basis each year but the £30,000 fee will not be creditable against other UK tax liabilities.

It seems highly likely that foreign authorities will not allow it to be creditable against foreign taxes. The Frequently Asked Questions released with the draft legislation unhelpfully say 'it is up to each individual country whether or not they consider the £30,000 charge to fall within the terms of their double tax agreement with the UK'.

All individuals (including those not yet falling within the seven year test) who elect to pay tax on the remittance basis will lose the benefit of their income tax personal allowances and capital gains tax annual exemption.

Individuals with substantial offshore income and gains will need to decide, before making their tax returns for 2008/2009 (ie by 31 January 2010) and for subsequent years, whether their offshore income and gains for the relevant year are such as to justify claiming the remittance basis, given the financial penalties for doing so.

Those whose offshore income and gains are less than £1,000 for the year will not need to make a claim to remain on the remittance basis, are not subject to the £30,000 fee and, it seems, will not lose their personal allowances and exemptions. However, there may be other traps (such as the

apparent inability to make retrospective principal private residence relief elections in the light of the new rules) which disadvantage all taxpayers who have previously been taxable on the remittance basis.

Source closing

At the moment it is possible to take advantage of the source-closing rule. Historically, this rule has enabled an individual claiming the remittance basis to remit investment income to the UK as if it were tax-free capital. This planning opportunity made use of the rule that income is only taxable if, when the income is remitted to the UK, the asset or the bank account giving rise to that income is held by the taxpayer.

As promised in the Pre-Budget Report, this opportunity is to be stopped. The legislation will be amended so that from 6 April 2008, investment income remitted to the UK will be subject to UK tax even if the source of that income is no longer in existence at the time of the remittance.

This change will apply retrospectively to tax income remitted to the UK after 5 April 2008 regardless of when the source of that income ceased to exist or to be held by the individual.

Individuals who have taken advantage of this planning technique in previous tax years, but have not yet remitted the funds to the UK, should consider bringing these funds onshore before 6 April 2008.

Order of remittance

The draft legislation also clarifies the order in which funds from a mixed offshore account are treated as received in the UK when remitted. These apply whether the funds are directly held or within a trust or other structure.

Until now, income has generally been treated as moving first, so remittances from a mixed income and capital fund have been taxed as income until the amount of income has been fully utilised.

Under the draft rules, the income moves first principle is confirmed, and income is subdivided into categories which are treated as remitted from a mixed fund in the following order:

- Employment income (excluding foreign employment income);
- Foreign employment income;
- Foreign investment income;
- Foreign chargeable gains; and
- UK investment income or capital.

This order is to be applied on an annual basis to any remittances rather than to the fund as a whole in the event of a remittance. Therefore it will not be possible to assume that all transfers from a mixed fund operate to remove income first, as distributions will likely be analysed on a yearly basis, so that if gains rather than income have been realised in any year and are matched with a distribution, the gains may be treated as being transferred prior to the income. This will be important for trusts because offshore distributions of income rather than capital will in future be potentially more attractive for beneficiaries of offshore trusts.

The draft legislation also makes no mention of the present capital gains practice of treating the proceeds of sales of assets standing at a gain as capital gain and original capital 'pro rata' to the relationship between the disposal proceeds and the cost price. It is not clear whether this is to be preserved going forward.

Extended definition of remittance

The long-standing anomaly that foreign investment income can be remitted in tax-free non-cash form is to be eliminated and aligned with the extended definition of remittance already applicable to foreign employment income and foreign capital gains. Doubts about the scope of the remittance rules applicable to foreign capital gains will also be removed. It will constitute a remittance to bring assets to the UK which were purchased with foreign income or gains and, as the legislation is currently drafted, there is a risk that taxpayers who have already brought such assets into the UK without generating a remittance will be deemed to make a remittance if those assets are still in the UK after 5 April 2008. It will also represent a remittance if foreign income or gains are applied offshore in payment for services provided in the UK.

It will not be necessary for the remittance to benefit the taxpayer directly. A remittance will arise if money or other property representing foreign income or gains is brought to the UK, or is received or used here, by or for the benefit of a 'relevant person'. 'Relevant person' is broadly defined to include both the taxpayer and a person 'connected' with the taxpayer. Connected persons are defined to include not only ancestors, siblings, spouses, civil partners and descendants but also a couple living together as if they were married or civil partners. A taxpayer is also connected with the trustees of a trust he settles and related companies. This change is intended to prevent the alienation of foreign income and gains offshore to close relatives, trusts and companies.

Offshore mortgages

A number of existing offshore mortgage arrangements will have to be carefully reviewed or unwound if the draft legislation is enacted in its present form.

The expanded definition of 'remittance' is likely to catch a number of structures using offshore loans to acquire a property in the UK. In particular, if offshore income or gains are used to fund interest on a mortgage which has been taken out to acquire property in the UK, it seems likely that the income or gains concerned will be treated as remitted to the UK.

Residence rules

Following the outcome of the *Gaines-Cooper* case, it was clear that the day count rules for determining UK tax residence would be modified. The draft legislation contains the provisions promised in the Pre-Budget Report ie from 6 April 2008, days of arrival and departure will be counted as days of presence in the UK for this purpose (even if the individual arrives and departs on the same day). There will be an exception for passengers who arrive in the UK in transit to another destination and who remain in an area of the port or airport only accessible to persons arriving in or departing from the UK (ie those days will not be counted). There is also a suggestion that an individual's purpose in spending time in the UK will be irrelevant to taxability ie that the old concession for eg medical emergencies will no longer apply.

The draft legislation strictly only applies to the 183-day rule but it seems that IR20 (which sets out HMRC guidance regarding the residence rules and the '90-day' rule) will be similarly amended with guidance to be provided to those whose average day count will span these changes. Unfortunately, the representations made by various professional bodies for the introduction of a statutory residence test have not lead to any further proposed changes.

Visitors who wish to ensure that they do not inadvertently become tax resident in the UK need to keep detailed records of their travel to and from the UK.

Temporary non-residence

The existing capital gains tax rule is to be extended to apply to foreign investment income, so that, where an individual has been resident in the UK and leaves for less than five years, any foreign income arising which is remitted to the UK during the period of absence will be taxable in the year of return.

This Stop Press only deals with what we consider to be the main issues for most non-UK domiciliaries and the trustees of offshore trusts in which they have an interest. It is based on our reading of the draft legislation issued on 18 January 2008. This is a very complex area and several issues remain uncertain.

HMRC are currently consulting on the draft provisions with a view to their inclusion in this year's Finance Bill. It is likely that changes will be made to some of the draft provisions during the legislative process which will take place before the Bill becomes an Act (which is not likely to be until the summer). However, it should be remembered that the provisions, if enacted, will take effect from 6 April 2008 and so it will be necessary to review the position and take decisions on the basis of the draft legislation before then.

Authors

John Riches

CONSULTANT | LONDON

Private client and tax

 +44 20 7597 6109

 john.riches@withersworldwide.com

Richard Cassell

OF COUNSEL | LONDON

Private client and tax

 +44 20 7597 6173

 richard.cassell@withersworldwide.com