September 2008

Finance Act 2008: changes to the taxation of non-domiciliaries and offshore trusts

In his Pre-Budget Report of November 2007, the Chancellor of the Exchequer Alistair Darling announced sweeping changes to the taxation of non-domiciliaries and offshore trusts.

The changes were widely regarded as ill-thought out and draconian, and following extensive lobbying, the measures were watered down when published as part of the Budget 2008. Since that date, the Finance Bill has been subject to extensive revision as it passed through Parliament and received Royal Assent on 21 July 2008. This note does not cover all of the new provisions, but discusses the measure most likely to affect individuals and trusts.

Residence

An individual is resident in the UK if he:

- Is present in the UK for 183 days in any one tax year; or
- Visits the UK for an average of 91 days or more a year over four consecutive tax years.

Prior to 6 April 2008, days of arrival and departure in the UK did not count as days spent in the UK, but from 6 April 2008, any day on which an individual is present at midnight will count as a day in the UK, subject to various exemptions for transit passengers. These exemptions will exempt a presence in the UK at midnight if the taxpayer is awaiting a transport connection between two places, to include transfers between different airports or forms of transport. However, a taxpayer should not undertake any form of activity which is not related to travel during this time, as this might prejudice the availability of the exemption. Individuals who travel to and from the UK on a frequent basis should keep careful records of their time in and out of the country.

The Remittance Basis

Individuals who are not domiciled (or in certain cases ordinarily resident in the UK) can choose to be taxed on their foreign income and capital gains only when remitted to the UK. The Finance Act 2008 introduces new rules for individuals who wish to continue to be taxed on this basis.

From 6 April 2008, such individuals will need to elect for this treatment each year on their UK tax return, but as a consequence they may be required to pay an additional tax charge of £30,000, and lose their annual income tax and capital gains tax allowances.

When the Chancellor’s initial proposals relating to this charge were published, it was to apply to any individual who had been resident in the UK for 7 out of the last 9 tax years immediately preceding the year in question, but the rules have now been amended so that the charge will not apply to individuals under the age of 18, although they will still have to submit a tax return claiming the remittance basis if they have UK income or gains in that year or have remitted any foreign income or gains.

Furthermore, individuals with less than £2,000 unremitted foreign income or gains will neither be required to claim the remittance basis nor be required to pay the charge, and will keep their entitlement to

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their personal tax allowances. The charge is not pro-rated for partial residence in the UK in any tax year.

The decision to claim the remittance basis can be made annually by 31 January following the year of assessment, so it will be possible to structure a person's tax affairs to take advantage of a claim to the remittance basis as appropriate, and spouses or families may also structure their affairs to limit their combined liability to the charge. Funds representing pure capital should continue to be segregated, as money from such an overseas account can still be brought into the UK without a charge to tax, and individuals may wish to change their investment objectives towards capital growth, or reduce (if possible) their unremitted income or gains to less than £2,000 a year.

If a person claims the remittance basis, they will not be obliged to disclose their overseas income and gains to HM Revenue & Customs, unless and until they are in fact remitted to the UK. The £30,000 charge is in addition to any tax payable on any remitted funds.

The £30,000 charge is to be regarded as an advance payment of tax on nominated income and gains that are not remitted to the UK. If the funds are remitted in future years no further tax is payable on those amounts, but they will be treated as the last amounts remitted to the UK in any tax year, and therefore a further tax charge may arise if income or gains are remitted. If payment of the £30,000 charge is made from a foreign source, this amount will itself be treated as remitted, unless it is paid direct to HM Revenue & Customs from a foreign bank account. When the payment was first proposed by the government, it was not immediately apparent whether it was intended to be an additional tax charge (thereby possibly preventing an individual obtaining a credit for it against their foreign tax liabilities) and although this has been clarified, there is still doubt as the availability of tax credit relief for UK resident US citizens.

It will be possible for a taxpayer to nominate less than the amount of income or gains needed to give rise to the full £30,000 charge as the legislation will then deem additional income to be sufficient to make up the sum. However, this deemed nominated income will not be treated as having already been taxed when income is remitted in the future.

If a person does not elect to be taxed on the remittance basis, they will then be taxed on the arising basis, and tax will become due on worldwide income or gains for that tax year, regardless of whether remitted. The individual will not then be liable for the £30,000 charge and will be entitled to their UK personal tax allowances, but will be obliged to complete a self assessment return.

Not electing for the remittance basis does not affect the individual's claim to be non-domiciled or a decision to elect to pay the charge in a future year. However, if the charge is paid for one year but not the next, the entitlement to personal allowances is lost for that subsequent year.

From 6 April 2008 the definition of "remittance" has been amended to include cash *or non-cash remittances* and payments offshore for UK linked services and debts. Items bought overseas out of unremitted income or gains will also now give rise to a tax liability when brought to the UK, unless they fall within the excepted items:

- Clothing, footwear, jewellery and watches purchased using relevant foreign income for individuals or members of their immediate family;
- Property brought to the UK for repair or restoration or for periods not exceeding 275 days;
- Works of art, antiques or collectors' items that are brought to the UK for public exhibition; and
- Property where the notionally remitted amount i.e. the value, is less than £1,000.

In every case, an income tax charge may still arise if the asset is sold in the UK.

Any asset purchased out of untaxed relevant foreign income which an individual owned at 11 March 2008 will be exempt from charge under the new remittance basis for so long as the individual retains it, even if the asset was outside the UK at that date and is later imported. Furthermore, any asset purchased out of untaxed relevant foreign income and in the UK at 5 April 2008 will also be exempt from charge for so long as the person owns it, even if the asset is exported and then re-imported at some point in the future.

Prior to 12 March 2008, it was permitted for remittance basis users to borrow money from a non-UK institution to purchase an asset in the UK, and to use untaxed offshore income to service the interest on the borrowings without this amounting to a remittance (although the repayment of the borrowing itself out of income or gains would have constituted a remittance). Since 12 March 2008, the payment of interest in this manner will now constitute a remittance, although transitional provisions will protect arrangements that were in place for the purposes of owning residential property at 12 March

2008 until 12 March 2028, provided the terms of the loan are not varied and no further advances are made.

Since 6 April 2008, the "source ceasing" loophole has also been closed. This enabled individuals to close a bank account at the end of one tax year, and remit the interest from it the following tax year without any tax liability arising. If funds are remitted from a bank account which contains source ceased income, a remittance will now occur. The possibilities for alienating income prior to its remittance to the UK tax free have also been reduced. Before 6 April 2008 it was possible for a non-domiciled individual to gift income or gains to another individual offshore, and for the donee to remit those funds to the UK without a tax charge, provided the donor did not benefit. Since the start of the new tax year, a taxable remittance will occur if the donee is the spouse or civil partner, minor child or grandchild of the donor, or a company with which one of those is connected, or a trust of which they are a beneficiary. It will still be possible to make offshore gifts to persons outside this list who can then remit tax free, for example to an adult child, but the donor must then be aware that a remittance may still occur if the funds are then applied for the benefit of one of the relevant individuals, for example minor grandchildren.

Capital gains tax rules which prevented a person who became non-resident on a temporary basis from realising gains free of tax have been extended to income.

Finally, changes have been made to the rules concerning the treatment of mixed funds and the matching of offshore income gains arising from non-qualifying offshore funds, and UK resident but non-domiciled persons claiming the remittance basis will now be entitled to relief for foreign losses.

Non-UK resident trusts

When Mr. Darling made his first announcements in November last year regarding the changes to the taxation of offshore trusts, it was widely predicted that the use of offshore trusts would be severely curtailed as a result. Whilst many of the harshest proposals have been withdrawn, non-domiciled beneficiaries of trusts and offshore trustees should be aware of the following changes.

Prior to 6 April 2008, UK resident but non-domiciled beneficiaries of non-resident trusts were not liable to pay capital gains tax on gains realised by offshore trusts, even if they later received capital in the UK. Now, benefits or payments received by non-domiciled beneficiaries in the UK are potentially chargeable to capital gains tax, when there are gains in the structure available to match against those benefits or payments. The rules that will apply to existing trusts depend on when the gains are realised and benefits or payments received:

- Capital gains realised before 6 April 2008 will continue to be outside the charge to tax, even when matched against benefits received after that date, provided the beneficiary is non-domiciled when the benefit is received;
- Benefits received pre 12 March 2008 and not matched against pre-6 April gains can be matched against later capital gains but this will not cause a tax charge to arise. The capital gain will then fall outside the scope of tax;
- Benefits received between 12 March 2008 and 5 April 2008 cannot be matched against later gains while the recipient remains non-domiciled;
- Where a benefit is received and the gain arises on or after 6 April 2008, the two will be matched and become chargeable on the beneficiary immediately, unless the remittance basis has been claimed.

The order of matching capital gains has also been amended, so that benefits received on or after 6 April 2008 will match against capital gains on a last in, first out basis, starting with the year of payment.

Non-resident trustees may elect in their self assessment tax return to rebase their trust assets, to include assets in underlying companies, as at 6 April 2008. On a subsequent disposal, the pre-6 April element of any gain will be available to match against capital payments made to non-domiciled beneficiaries on or after that date, but no charge to tax will arise. The election will affect beneficiaries who are non-domiciled both at the time of the gain and when the benefit is received, and trustees may wish to consider obtaining valuations of chargeable assets as at 6 April 2008. As a result of an election, non-domiciled beneficiaries can only then be taxed on the increase in the value of trust assets post 6 April 2008, and trustees will need to keep detailed records of gains arising in a structure, especially if they have a mixture of domiciled and non-domiciled beneficiaries. The earliest date when the first election will need to be made is 31 January 2010, but the actual timing of the election will depend on when benefits or payments are in fact made to UK resident beneficiaries.

For many years, anti-avoidance rules have meant that capital gains tax rates could be as high as 64% on capital payments made to domiciled beneficiaries of

non-resident trusts when significant amounts of gain have been allowed to build up offshore and its distribution has been postponed. As from 6 April 2008, the maximum rate will now be reduced to 28.8%, as a consequence of the reduction in the rate of capital gains tax for higher rate taxpayers from 40% to 18%.

The exemptions from the "transfer of assets abroad" legislation for non-domiciliaries have been limited. Where a non-UK structure has been established by a UK resident individual, the income arising to the structure will be deemed to be "foreign income" to the extent that it would be foreign income if it were in fact the individual's. If the remittance basis is claimed the "deemed foreign income" need not be declared on the non-domiciliary's tax return, but the extended remittance rules will now apply to the "deemed relevant foreign income" or any income or benefit that is derived from it. UK sources of income eg. rental income from UK property will need to be declared. If capital and income are properly segregated, it will still be possible for a transferor to remit pure capital and avoid a charge. The above rules will also apply to non-transferors, and new matching rules will apply to non-transferors such that the earliest income treated as arising is set against the earliest benefits received, and so forth.

The attribution rules which attributed the gains of certain offshore companies to UK domiciled individuals have been extended to apply to non-domiciled but resident taxpayers, subject to the remittance basis for non-UK assets. If the gains are made by an offshore company held by a non-resident trust the gains will be attributed as described above, subject to the remittance basis.

Finally, the Finance Act 2008 has not amended the rules relating to "excluded property trusts" i.e. that overseas assets comprised in an offshore trust created by a non-domiciled settlor are outside the scope of Inheritance Tax, even if the settlor later becomes "deemed domiciled" in the UK.

Conclusion

The final form of the legislation is fundamentally different from the government's proposals of November last, but the complexity of the new legislation means that each specific instance will need to be carefully reviewed to establish the tax treatment of an individual or a trust.

If you require any further information, please contact your usual contact in the Private Client department of Payne Hicks Beach, or the Head of the Department Alice Palmer on 020 7465 4300 or apalmer@phb.co.uk

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This bulletin is not intended to provide a comprehensive statement of the law. It is intended to highlight some issues current at the date of its preparation. Specific advice should always be taken.

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