REFORM OF THE TAXATION OF NON-DOMICILED INDIVIDUALS

BRIEFING

OVERVIEW

June 2011

On 17 June 2011 two Consultation Documents were issued:

- Statutory definition of tax residence
- Reform of the taxation of non-domiciled individuals.

The proposals for a statutory definition of tax residence are the subject of a separate briefing.

The Consultation Document on the taxation of foreign domiciliaries makes clear that the Government does not intend to change the broad principles underlying the Remittance Basis. However, as announced in the 2011 Budget, it intends to introduce reforms which it believes strike a balance between increasing the tax contribution from foreign domiciliaries who are long-term UK residents and encouraging inward investment in the UK. The changes will be enacted in Finance Act 2012 and take effect from 6 April 2012.

The reforms proposed comprise:

- Remittance Basis Charge increased to £50,000 for adult longer term UK residents
- New exemption for commercial investment in UK qualifying businesses
- Simplification of the existing Remittance Basis rules in respect of:
  - Nominated income
  - Foreign currency bank accounts
  - Taxation of assets remitted to and sold in the UK
  - Enactment of the existing practice in relation to foreign employment duties of non-ordinarily resident taxpayers.

The Consultation Document repeats the commitment made by the Chancellor in the 2011 Budget that, following these reforms, there will be no other substantive changes to the taxation of foreign domiciliaries for the remainder of this Parliament.

1. THE £50,000 HIGHER REMITTANCE BASIS CHARGE

One of the principles underpinning the Finance Act 2008 was that, with limited exceptions, those who claim the Remittance Basis should suffer a financial penalty. From 2008/09 onwards, (and unless foreign income and/or gains are less than £2,000 in aggregate), claiming the Remittance Basis involves the loss to the personal allowance and the Capital Gains Tax annual exemption. In addition, adult foreign domiciliaries, resident in at least seven of the preceding nine tax years, have had to pay a £30,000 Remittance Basis Charge to claim the Remittance Basis.

From tax year 2012/13 there will be two levels of Remittance Basis Charge:

- The standard £30,000 charge, payable by individuals who (as now) have been UK resident in at least seven out of the nine preceding tax years.
- A higher £50,000 charge, payable by individuals who have been UK resident in at least 12 out of the 14 preceding tax years.

It appears that the mechanics of the higher Remittance Basis Charge will be identical to the current £30,000 charge.

Whether the standard or higher charge applies, taxpayers – provided they remain domiciled outside the UK - will continue to be free to choose year by year whether to be taxed on the Remittance or the Arising Basis for the relevant tax year.

Foreign domiciliaries may be concerned that this rise could be a prelude to further increases. The Consultation Document states that: “It would be counter-productive to go further and introduce more stringent tax measures that could drive many non-domiciles away or deter them from coming to the UK in the first place.”

It is hoped (though not confirmed) that payment of the higher Remittance Basis Charge will constitute an exempt remittance, if the conditions currently in force for the £30,000 Remittance Basis Charge are met.

Adult UK resident foreign domiciliaries who have been continuously UK resident from or before the tax year 2000/01 will have to pay the higher charge to use the Remittance Basis (unless their aggregate unremitted foreign income and/or gains for the tax year are less than £2,000). For those who have not been continuously resident since 2000/01 the look back period for 2012/13 for the higher charge is from the tax year 1998/99.

For both the basic and the higher Remittance Basis Charge, a period of non-UK residence of three complete tax years is required to re-set the clock; after that the individual can return and claim the Remittance Basis without immediately having to pay the charge.

2. EXEMPTION FOR COMMERCIAL INVESTMENTS IN UK BUSINESS

Overview

Recognising that the current Remittance Basis rules discourage UK resident foreign domiciliaries from investing in the UK, a special new exemption is to be introduced. The exemption will disapply the remittance rules with respect to remittances of foreign income or gains used to invest in a qualifying business. It seems that the exemption will apply not only to direct investment by the taxpayer, but also to investment by any other relevant person. The Consultation Document refers specifically to the exemption applying to funds held in offshore trusts and companies, which would currently be taxable on the individual if used in this manner.

The investment must be in a qualifying business. Investment in UK business assets alone will not come within the terms of the current proposed exemption. To be a qualifying business the following conditions must be met:

- it must take a Qualifying Form;
- it must be either UK resident or have a permanent establishment in the UK; and
- there must be a Qualifying Business Activity.

Provided the conditions are met, there is to be no upper or lower limit on the amount of Remittance Basis income and gains that can be invested.

There will be specific anti-avoidance provisions aimed at preventing taxpayers from exploiting the new rules for non-commercial purposes. Specifically the Government wants to prevent:

- foreign domiciliaries investing in low-risk business for a limited period and then deriving a personal benefit in the UK; and

- the investment being applied for non-commercial purposes.

The business must take a Qualifying Form

The Government proposes that to qualify the business must take the form of a company. The Consultation Document makes it clear that allowing investment in a partnership, a UK trust or a sole trader's business is seen as offering too many opportunities for avoidance. This restriction may be considered a serious defect in the proposals, particularly as many professional and financial sector businesses are constituted as partnerships. It is hoped that the Government will be persuaded that concerns over avoidance can be dealt with, and that the relief should be extended to partnerships in particular.

A company will not have to carry out the qualifying business activity itself, but can be an investment company, provided it only holds shares in businesses which:

- are companies (no minimum ownership requirement so the shares held could be a minority stake – private equity companies and venture capital companies could qualify);
- are resident in the UK or have a permanent establishment in the UK; and
- carry out Qualifying Business Activities.

The exemption will apply to investment in both share and loan capital.

There are no restrictions with respect to any connection between the taxpayer and the company nor any requirements for a minimum level of shareholding. There is no prohibition against investing in family companies and it appears that relief will be due even where the company is wholly owned by the taxpayer and he or she is a remunerated director. There are anti-avoidance provisions to claw back relief in cases where the remuneration received is not commercial.

The business must be either UK resident or have a permanent establishment in the UK

Relief is not restricted to UK resident companies nor is there apparently to be a requirement that the trade is carried out wholly or mainly in the UK. It is intended that the exemption will also apply to investment in qualifying companies which are non-UK resident but have a permanent establishment in the UK.

Qualifying Business Activities

For a business to qualify a substantial proportion of its overall activities must consist of:

- engaging in trading activities carried out in a commercial manner; or
- the development or letting of commercial property.

Furthermore, certain activities are excluded. It appears that any level of excluded activity may disqualify a business. The following will be excluded activities:

- holding and letting residential property (with a let out for building and development activities, and commercial trading activities in connection with nursing homes and hospitals);
- leasing of tangible movable property (yachts, cars, furniture, pictures); and
- the provision of personal services (nannies, cooks, chauffeurs).

The Government is undecided to whether the relief: (i) should be a wide relief which extends to companies listed on a recognised stock exchange or (ii) it should be focused on unlisted companies and companies quoted on exchange regulated markets such as AIM and PLUS quoted.

Anti-avoidance provisions

It is proposed that in the event of a disposal or realisation, the exempt remittance will become taxable unless, within two weeks, an equivalent amount is:

- taken out of the UK; or
- re-invested in a qualifying investment.

Rather than have complicated identification rules, the amount of remitted income and/or capital gains will be identified with the first amounts of value extracted from the company other than through permitted commercial payments.

As noted above, nothing will prevent the payment of commercial levels of remuneration, or the payment of dividends or interest out of the business profits realised after the investment. There will be specific sanctions aimed at preventing the funds being used to provide uncommercial benefits to the taxpayer or anyone connected with him.

Thus, it will not be permissible for the company:

- to use the funds invested to guarantee loans to the individual; or

- to make payments to a third party which are linked to payments made to the individual.

The exemption is intended to encourage new investment in the UK and will not be available to allow a taxpayer to realise value from an existing business.

Claiming the relief

The current proposal is that the relief should be claimed through the self-assessment tax return for the relevant year (that is the year of remittance). It is envisaged that the disclosure will cover:

- the level of Remittance Basis income or gains brought to the UK under the terms of the investment exemption;
- the business in which the investment has been made.

It is assumed that the exemption will be available in respect of any Remittance Basis income or gains, regardless of whether the Remittance Basis is claimed for the year in question. In other words, electing for the arising basis in a given tax year will not preclude relief if the individual makes a qualifying investment using prior years' Remittance Basis income and/or gains.

3. SIMPLIFYING THE EXISTING REMITTANCE BASIS RULES

Overview

The Remittance Basis has never been a simple regime, but there is widespread feeling that Finance Act 2008 raised the levels of complexity to such an extent that it is impossible for some to be fully compliant. Whilst recognising that a certain level of complexity is inherent in the regime, the Consultation Document commits to simplification where possible. Three objectives are set down against which all simplification proposals will be evaluated:

- no material Exchequer cost (either directly or through opening up new opportunities for tax avoidance)
- clear and material benefits, either delivered by a reduction of administrative burdens or greater certainty
- no requirement for complex legislation.

The reforms the Government proposes are in relation to:

1. Nominated income
2. Foreign currency bank accounts
3. The taxation of assets remitted to and sold in the UK
4. The enactment of the existing practice in relation to foreign employment duties of non-ordinarily resident taxpayers

In addition, it is stated that the Government will consider simplifications in other areas provided the suggestions conform to these three objectives.

Nominated income

The provisions with respect to the Remittance Basis Charge and the requirement to make an actual nomination of foreign income or gains, are highly complex. The penal rules which apply if nominated income or gains are remitted are particularly onerous. The rules have led to the creation of specific accounts to ring-fence the funds nominated and much professional time has been spent explaining and supervising this process. Recognising that the lengths to which the legislation is making taxpayers go are excessive and unnecessary, it is proposed to modify the rules so that the penal matching provisions will not apply to up to £10 of nominated income or gains.

This would allow £10 of nominated income or gains to be remitted free from UK tax. The amount is so small that the tax impact is not significant. The important point is that from 2012/13 onwards an individual, by making an actual nomination of £10 or less of foreign income or gains, will be able to ensure that the penal matching rules will never apply to them. Most taxpayers have been nominating token amounts in order to have to ring-fence as little as possible. From 2012/13 onwards, this ring-fencing will not be necessary.

Foreign currency bank accounts

Under the current Capital Gains Tax rules foreign (non-sterling) currency within a bank account is a chargeable asset. There is an exemption where the currency is acquired and used for personal expenditure outside the UK but this is of limited value. For foreign domiciliaries the administrative burden of computing gains on foreign currency transactions is particularly onerous. The operation of a foreign currency bank account can potentially give rise to numerous disposals which, under the current rules need to be taken into account.

The Government proposes to remove sums within a foreign currency bank account from the scope of Capital Gains Tax. It is suggested that some anti-avoidance provisions will be required, presumably to counter schemes which are devised artificially to generate an allowable loss equivalent to an exempt currency gain.

Taxation of assets sold in the UK

Under the current legislation there are a number of exemptions where non-monetary assets purchased outside the UK with Remittance Basis income and/or gains are subsequently brought to the UK. These are:

- the public access rule (relating, for example, to eminent works of art);
- the personal use rule (applicable only to clothing, footwear and jewellery);
- the repair rule;
- the temporary importation rule (the property must not have been in the UK for more than 275 days in aggregate) and
- the de minimis provision where the notional remitted amount is less than £1,000.

However, notwithstanding these exemptions, the Remittance Basis income or gains used to acquire the asset will fall into charge if the asset is sold in the UK. This makes the UK unattractive as a place for the sale of assets owned by UK resident foreign domiciliaries. The Government, therefore, proposes to extend the current importation reliefs so as to enable UK resident foreign domiciliaries to sell assets, falling within the above exemptions, in the UK without crystallising a charge on any Remittance Basis income and gains used in their acquisition. Provided all of the proceeds from any sale are removed from the UK within two weeks of the money being received by the individual, there will be an exemption from any tax charge attributable to the remittance. What happens to the actual asset itself after the sale is irrelevant to the operation of the exemption (assuming that a genuine third party sale has taken place).

It appears that these new provisions will allow for the import of any asset for sale provided the total time the asset has been in the UK when the sale takes place is less than 275 days.

It is not clear whether the proposed exemption is limited to the income and gains used to acquire the asset or will extend to any capital gain on sale. It is hoped that it will be the latter as this would attract most business to UK auction houses, and would be consistent with the proposed requirement that all proceeds be exported if the exemption is to apply.

Statement of Practice 1/09: Employees with duties in the UK and overseas

Where an individual is a Remittance Basis user and ordinarily resident in the UK, the Remittance Basis in respect of earnings is available only where the foreign employment is with an overseas employer, and the duties are wholly performed abroad (with the exception of incidental UK duties). By contrast, for a Remittance Basis user who is not ordinarily resident in the UK, a single contract can cover UK and foreign duties, with the earnings relating to foreign duties being taxed on the Remittance Basis (the salary will need to be paid initially into an offshore account). Statement of Practice 1/09 deals with the operation of this special offshore account. Provided the conditions are met, it disapplies the standard mixed fund rules and allows for pragmatic and more beneficial matching rules to apply. Since the Statement of Practice has a concessionary element, it was recognised that it had to be enacted at some point. The Government is taking this opportunity to do so and consult on some of the more complicated issues that can arise with these special accounts, such as share scheme transactions.

4. CONCLUSION

Following the conclusion of this consultation process the taxation of foreign domiciliaries will not be addressed again in this Parliament. As such, there is a unique opportunity to contribute to a consultation process where there seems to be a genuine desire to simplify the legislation and remove disproportionate administrative burdens. It is to be hoped that the process will result in further simplification measures being adopted. We will be taking a full part in the consultation process and will circulate an update on developments when draft legislation is available.

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