

REFORM OF THE TAXATION OF NON-DOMICILED INDIVIDUALS



OVERVIEW

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.

As a firm we submitted detailed representations to HM Treasury/HMRC on these proposals. We set out below a summary of the proposals for the reform of the taxation of foreign domiciliaries and, in italics, incorporate into the analysis our main comments and responses. We have participated in direct discussion with HM Treasury/HMRC on these points.

The consultation period closed on Friday 9 September 2011. A summary of responses will be produced (at the same time as, or slightly in advance of, the draft legislation, which itself is expected to be published on 6 December 2011). The objective is for final legislation to be included in Finance Bill 2012, to take effect from 6 April 2012 onwards.

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. Section 1 of this briefing provides a summary of the current proposals, with sections 2 to 4 going into greater detail.

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 PROPOSALS AT A GLANCE

The reforms proposed comprise:

- An increase in the Remittance Basis Charge to £50,000 for adult longer term UK residents.
- A new exemption for commercial investment in UK qualifying businesses.
- The simplification of the existing Remittance Basis rules in respect of:
 - Nominated income
 - Foreign currency bank accounts
 - The taxation of assets remitted to and sold in the UK
 - The enactment of the existing practice in relation to foreign employment duties of non-ordinarily resident taxpayers.

Rawlinson & Hunter comments

Broadly we support the proposals contained in the Document. However, we have some concerns which we have raised in our response.

Our key points are:

- *That the current proposals for the business investment exemption should be extended to:*
 - *allow investment in commercial businesses generally, but most particularly into businesses carried on through partnerships (including limited liability partnerships); and*
 - *permit investment in businesses without a Permanent Establishment (“PE”) in the UK to qualify, at least where the business invests in UK commercial property and/or commercial/residential development projects.*
- *That the proposed Capital Gains Tax exemption for foreign currency bank accounts should apply to all taxpayers and relevant persons (including trustees), and that the opportunity should be taken to clarify the rules with respect to the remittance of income received in a foreign currency.*
- *That the proposed exemption for assets, acquired with remittance basis income or gains, and brought to the UK for sale,*

should extend to the import for sale by any relevant person, and allow for deferral of liability to Capital Gains Tax on the disposal (if the proceeds are exported within the prescribed period).

There are also a number of areas where we consider the opportunity should be taken to simplify and/or clarify the legislation (see section 4 for a summary of these areas).

2. 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 (unless foreign income and/or gains are less than £2,000 in aggregate), claiming the Remittance Basis involves the loss of 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 (as now), payable by individuals who 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 understood 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. This should be confirmed in the draft legislation.

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.

3. 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 PE 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 be either UK resident or have a PE in the UK

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

The business must take a Qualifying Form

The Government proposes that, to qualify, the business must take the form of a company. It considers that allowing investment in a partnership, a UK trust or a sole trader's business would offer 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. In our submission to HM Treasury/HMRC we have maintained 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 meaning that private equity companies and venture capital companies could qualify);
- are resident in the UK or have a PE 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 given 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.

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.

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 and chauffeurs).

The Government is undecided as 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 PlusQuoted.

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 understood 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. This needs to be made clear in the draft legislation.

Rawlinson & Hunter comments

We, broadly, welcome the provisions which for the most part envisage a relief which is widely drawn and will apply to investments made, not only by the taxpayer but by any relevant person. There are, however, some significant issues with the current proposals which we hope will be addressed in order to maximise the success of the new relief.

Concerns have been expressed that these proposals may be challenged under EU provisions against state aid. We understand that HM Treasury/HMRC officials will look more closely at this issue before draft legislation is released, and hope that approval can be obtained.

Qualifying business definition:

Our main concerns with the proposals are with respect to the conditions that:

- *a qualifying business must be structured as a company; and*
- *a foreign business can only qualify for the relief if it has a PE in the UK.*

In principle, we feel that investment in any type of permissible business activity should be eligible for the exemption and that the exemption should also cover investment on a commercial basis in UK property whether or not the business has a PE in the UK.

Any concerns that the new exemption might be exploited for tax avoidance purposes (which we believe centre around sideways loss relief) could be dealt with relatively easily (by restricting sideways loss relief to funds becoming taxable on the withdrawal of the exemption). We feel strongly that relief for investment in partnerships in particular should be permitted and have put forward detailed arguments as to why this would be good for the UK economy.

Types of qualifying business activity

Broadly, we are satisfied with the provisions outlined in the Consultation Document. Our one reservation is with the exclusion for holding and letting residential property. We have suggested that investment in residential property should be allowed where it is conducted on a wholly commercial footing and where no accommodation is provided to a participator or connected person.

Should the exemption also apply to listed companies?

We believe that extending the incentive to listed companies would result in additional inward investment and cannot see how it would introduce additional complexity into the provisions.

Exporting funds within two weeks of a disposal

It is reasonable that there should be a requirement to export (or re-invest) funds withdrawn or realised within a limited period. However, we consider the period should allow for funds being held in escrow or otherwise not freely available to the investor. The period should, therefore, commence only when funds are at the absolute disposal of the investor. In many cases this will mean that there are different deadlines for different tranches of proceeds.

The following points need to be clarified by the draft legislation:

- that the requirement for export or re-investment will not apply to any gains realised which are chargeable to UK tax; and*
- that the re-investment provisions can apply where proceeds are taken out of the UK within the two week period and then re-imported to re-invest in another qualifying investment.*

The draft legislation will also have to contain

provisions covering part disposals. A simple requirement that proceeds are deemed to derive from exempted funds until the entire exempt amount has been exported will not work in such circumstances without a special additional exemption applying to funds retained or remitted to pay CGT liabilities on a part disposal, if the proceeds remaining in the UK are insufficient. We have suggested that where there is a part disposal, it would be better to require only pro rata export or re-investment.

4. SIMPLIFYING THE EXISTING REMITTANCE BASIS RULES

Overview

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

Rawlinson & Hunter comments

The remittance basis will never be simple but we believe that it is possible to simplify the current provisions, to make their operation clearer and reduce the risk of inadvertent non-compliance and unfairness within the tax system. As such we have made a number of detailed proposals concerning additional simplifications and clarifications. Our suggested proposals cover the following areas:

- *Simplifying and clarifying the remittance definition.*
- *Providing an exemption for travel costs (or at least allowing reasonable apportionment of travel costs between UK and foreign travel).*
- *Easing compliance burdens and reducing cases of unintended non-compliance.*
- *Simplifying and clarifying the mixed funds rules.*
- *Adjusting the anti-avoidance provisions in s13 TCGA 1992, so that foreign domiciliaries whose funds are held within entities more akin to a company than a trust are not disadvantaged unfairly.*
- *Modifying the legislation where the remittance basis provisions are not currently adequately catered for (such as with reporting funds which do not distribute their income and with entrepreneurs' relief).*

Nominated income

The provisions with respect to the Remittance Basis Charge (RBC), 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. 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.

Rawlinson & Hunter comments

This suggested simplification is good news for taxpayers who have to pay the RBC. Particularly in the light of the recent announcement by the IRS with respect to the credibility against US tax of the remittance basis charge, the proposal appears to us to be effective in:

- *removing the administrative burden which the RBC provisions impose currently on affected taxpayers; and*
- *maintaining the creditability of the charge in foreign jurisdictions.*

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.

For individuals, the Government proposes to remove sums within foreign currency bank accounts 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.

Where possible individuals would from, a tax perspective, be better delaying any withdrawals or transfers from foreign currency accounts where a gain will be crystallised until after 5 April 2012. This may, of course, not make commercial sense or not be practical. As ever each situation requires consideration on its merits.

Rawlinson & Hunter comments

Again the suggested simplification is welcome. However, the exemption should extend to trusts. In our practical experience foreign currency issues

can be a significant tax compliance issues for trustees and we hope that the draft legislation will apply to all taxpayers and investment vehicles.

We are unconvinced of the need for anti-avoidance provisions to prevent exploitation of the exemption through artificially creating an allowable loss equivalent to an exempt currency gain. We consider that the provisions within the current Capital Gains Tax losses targeted anti-avoidance rule would prevent such a loss being allowable and that no new legislation is required.

Whilst the proposed Capital Gains Tax exemption is a valuable simplification we feel that the opportunity should be taken to address the issues with respect to foreign income received in a foreign currency. This is currently a very difficult area with no agreement as to the correct treatment. We have submitted detailed technical comments with respect to how we feel this issue could be addressed.

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, particularly works of art and collectibles, owned by UK resident foreign domiciliaries. To address this issue, where one (or more) of the existing exemptions applies, the Government proposes to allow UK resident foreign domiciliaries to sell assets, in the UK without crystallising a charge on any Remittance Basis income and/or 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 will be irrelevant to the operation of the exemption (assuming that a genuine third party sale has taken place). We understand that the exemption will apply to assets imported by any relevant persons in relation to the taxpayer. It is hoped that the draft legislation will make this clear.

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

Rawlinson & Hunter comments

We support the objective behind this proposed new exemption. However, as it stands we do not feel that it will achieve the desired objective (of encouraging the sale of art and collectibles though the UK) unless there is also a provision to defer or conditionally exempt tax on any gains realised, where these are exported within the time limit provided.

Often artworks offered for sale will have appreciated in value, or the acquisition cost may be unknown. In such cases, even if the preferred place of sale for the work of art would be the UK, the increased proceeds that might be obtained through a UK auction house or dealer will not offset the 28% Capital Gains Tax liability (which would be avoided if the sale were to take place abroad). As such without a Capital Gains Tax exemption the measure is unlikely to be successful.

We also have concerns about the two week time period for removing the proceeds from the UK. Auction houses frequently pay over proceeds sometime after the sale, and often not until the purchaser has settled. In addition some sales may involve arrangements for deferred payment or instalments. As such we have suggested that the permitted export period should commence only when funds are freely disposable by the vendor.

To encourage foreign domiciliaries to gift assets to the Nation we have suggested a new exemption where assets (which would have to satisfy the criteria for being considered as pre pre-eminent) are brought into the UK and gifted to the Nation.

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 an exception for incidental UK duties). By contrast, in the case of 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 to consult on some of the more complicated issues that can arise with these special accounts, such as share scheme transactions.

Rawlinson & Hunter comments

We support the enactment of SP1/09 and we have suggested that the opportunity be taken to address all the outstanding issues with respect to the remittance basis and employment taxation.

5. CONCLUSION

Following the conclusion of this consultation process the taxation of foreign domiciliaries will not be addressed again in this Parliament. To date the consultation experience has been positive with goodwill on all sides. It is to be hoped that the Government will respond positively to the representations made, that existing proposals will be modified so as to better meet the objectives and that further simplification measures will be put through.

A Response Document will be published which will discuss the representations made and the Government's conclusions. This is expected to be released shortly before the anticipated date for the publication of draft legislation (6 December 2011 as part of the wider release of draft legislation in connection with announced Finance Bill 2012 measures). We will provide an updated briefing paper at that time.

There will be an opportunity, closing on 10 February 2012, for representations on the draft legislation. We will continue to take a full part in the consultation process.

The information contained in this briefing does not constitute advice and is intended solely to provide the reader with an outline of the provisions. It is not a substitute for specialist advice in respect of individual situations.

Rawlinson & Hunter is a partnership registered to carry on audit work in the UK and regulated for a range of investment business activities by the Institute of Chartered Accountants in England and Wales. Details about our audit registration can be viewed at www.auditregister.org.uk under reference C005362660.

Rawlinson & Hunter Chartered Accountants

Eighth Floor
6 New Street Square
New Fetter Lane
London EC4A 3AQ

And at

Lower Mill
Kingston Road Ewell
Surrey KT17 2AE

T +44 (0)20 7842 2000
F +44 (0)20 7842 2080
firstname.lastname@rawlinson-hunter.com
www.rawlinson-hunter.com

Partners

Chris Bliss *FCA*
Simon Jennings *FCA*
Philip Prettejohn *FCA*
Mark Harris *FCA*
Frances Jennings *ACA*
David Barker *CTA*
Kulwam Nagra *FCA*
Ben Melling *FCA*
Paul Baker *ACA*
Sally Ousley *CTA*
Derek Rawlings *FCA*
Andrew Shilling *FCA*
Craig Davies *ACA*

Directors

Lynnette Bober *ACA*
Phil Collington *CTA*
Mike Cunningham *ACA*
Karen Doe
Chris Hawley *ACA*
Nigel Medhurst *AIIT*

Consultants

Ken Dent *FCA*
Bob Drennan *FCA*
Ralph Stockwell *FCA*