

# THE TAXATION OF UK RESIDENT NON-DOMICILIARIES (“RNDs”)

The 2008 Finance Bill received Royal Assent on 21 July and so the substantial changes to the taxation of RNDs are finally law. The form of the legislation is very different from both the original proposals and from the various initial drafts - even during the Bill's passage through Parliament, the Government tabled a virtually unprecedented number of amendments. The new regime may not be as radical as originally envisaged, but it has still dramatically changed the landscape for the taxation of RNDs. The reforms relate to two main areas: the taxation of offshore trusts and companies; and the remittance basis. There are also some changes to the rules for determining tax residence.

References to 5 April are to 5 April 2008, being the date from which all of these changes apply.

## WHAT IS AN “RND”?

An RND is the term used in this note to refer to a person who is **resident** in the UK for tax purposes but **not domiciled** in the UK.

A full discussion of the rules which determine ‘residence’ and ‘domicile’ is outside the scope of this note, but it is possible - and quite common - for someone from overseas to come and live in the UK for a period, becoming resident here but remaining domiciled abroad for UK tax purposes.

Very broadly, residence is determined by physical presence for the requisite number of nights spent in the UK in a tax year, whilst domicile requires the intention to remain here permanently or indefinitely. In practice, the rules are much more complex than this and so the first step for individuals who may be affected is to investigate properly their residence and domicile status - preferably well in advance of their arrival in the UK.

## OFFSHORE TRUSTS

The general rule is that non UK residents are not liable to UK Capital Gains Tax (“CGT”) and this applies to non-resident trustees. However, offshore trust gains can be taxed either on the settlor or the beneficiaries of the trust as follows:

### **The Settlor Charge (Section 86 TCGA 1992)**

The original proposal for extending the settlor charge to non-domiciled settlors has been dropped and the rules here therefore have not changed.

A UK resident and domiciled settlor of an offshore trust which is “settlor interested” remains liable to CGT on all gains accruing to the trust (“trust gains”) on an “arising basis” (i.e. trust gains will be attributed automatically to the settlor as and when they are realised). The definition of “settlor interested” is very wide and includes a trust under which the settlor, his spouse, children or grandchildren can potentially benefit. Nevertheless an RND settlor is still not liable for CGT unless he receives a payment or benefit from the trust, in which case the beneficiary charge described below applies.

### **The Beneficiary Charge (Section 87 TCGA 1992)**

Where the settlor charge does not apply, gains realised by non-resident trustees are matched against and taxed upon beneficiaries who receive capital payments from the trust. Capital payments include being allowed to live in a trust property or receiving an interest free loan, as well as the receipt of money.

Under the old rules, trust gains matched against capital payments to non-domiciled beneficiaries escaped CGT, even if the beneficiary was UK resident. Now, if any UK resident beneficiary (whether domiciled or not) receives a capital payment from an offshore trust which can be matched with trust gains, the beneficiary will be liable to CGT. The only exception is for an RND beneficiary who claims the remittance basis (see below), in which case he is only liable if the capital payment is remitted to the UK. Capital payments to non-UK residents effectively remain non-taxable.

### *Section 87 matching rules*

There are complex matching rules setting out which trust gains are matched to which capital payments. The system has totally changed so that a Last In First Out (LIFO) basis now applies, as opposed to a First In First Out (FIFO) basis. The effect is that, from this tax year, later trust gains are matched with capital payments first but for previous tax years, older trust gains are attributed first.

- Trust gains realised (or accruing but not realised where a rebasing election has been made – see below) before 6 April can be matched with capital payments to an RND beneficiary after that date but will not be taxable.
- Capital payments made before 12 March (budget day) to an RND beneficiary can be matched with trust gains accruing after that date but again are not taxable.
- Capital payments to RNDs made between 12 March and 5 April are ignored. This provision was designed to prevent trustees making large capital payments to RNDs after the new rules were announced on budget day but before 5 April to “wash out” future trust gains tax free.

It is important to bear in mind that the relevant time for assessing the residence and domicile of a beneficiary is when the charge arises i.e. when a capital payment is matched to gains. Therefore if a beneficiary was RND pre-6 April when a payment was received, but domiciled when gains are realised post 5 April, the matched payment will be taxable on the arising basis.

### *Rebasing*

Trustees can make an irrevocable election that the trust assets are deemed to be disposed of and reacquired at market value on 6 April 2008. This is known as “rebasing”. The election must apply all assets held by the Trustees directly or by an underlying company on or before the 31 January occurring after the end of the first tax year after 2007/08 in which a capital payment is received by a UK resident beneficiary or in which the trustees transfer all or part of trust fund to trustees of another settlement.

Rebasing is a very useful tool where a trust has an RND beneficiary because the effect is that he will not pay tax on any element of a gain which accrued in the 2007/08 tax year or before. If trustees do not rebase, the RND beneficiary will be liable to tax on the whole gain. Rebasing is not relevant if a trust has no RND beneficiaries and may not be worthwhile where the trust contains pre 5 April losses.

It is important to note that the deadline for electing to rebase starts from when any UK resident beneficiary receives a capital payment not just an RND beneficiary and so the trustees might have to make a decision about rebasing before it becomes relevant. If a UK resident beneficiary currently has the use of a UK house, this will constitute a capital payment and so the Trustees will need to consider if an election should be made prior to 31 January 2010.

### *Supplementary Charge*

A CGT “surcharge” of 10% of the CGT liability is levied for each complete tax year up to a maximum of 6 years between the date when the trust gain was realised and the date of the related capital payment. The maximum effective rate is now 28.8%.

Under the old FIFO rules, it was more likely that a supplementary charge would arise and that the effective tax rate would be higher. However, because of the new LIFO rule, CGT will always be paid at the lowest available rate first.

Where a capital payment is made to an RND beneficiary, it is the delay between the gain being realised and the payment being made that counts for computing this charge. No account is therefore taken of when the payment is actually remitted.

### **Offshore Income Gains for Trustees**

Offshore Income Gains arising on the disposal of certain types of offshore investment funds are attributable to UK resident beneficiaries and chargeable under Section 87 when matched against capital payments in the same year. From 5 April, offshore income gains accruing after that date can be attributed to RNDs on the remittance basis (if it is claimed).

If any offshore income gains cannot be matched to current year capital payments, they must be analysed under the Transfer of Assets Abroad legislation (see below). If those rules do not apply, the offshore income gains must be matched against capital payments under Section 87.

Whichever provisions they fall under, offshore income gains are taxed as income at 40% or 20%, rather than the lower CGT rate of 18% and so investment products generating these gains are not as attractive as they once were.

### **Transfer of Assets Abroad**

Where income accrues to a person (including a trust or a company) outside the UK as a result of a transfer of assets, anti-avoidance provisions can apply to attribute that income to UK residents. The income is attributed either to transferors who have power to enjoy that income or to individuals who did not make the transfer but who receive benefits from the trust or person to whom the income accrues.

RND transferors were able to use the remittance basis prior to 5 April but changes have now been made to ensure that the new remittance rules apply (see below).

## **OFFSHORE COMPANIES – SECTION 13 TCGA 1992**

Capital gains made by a non-UK resident company which (broadly) has five or fewer shareholders or in which all shareholders are directors (“section 13 companies”) can be attributed to and taxed on UK resident shareholders who have more than a 10% interest in the company and to non-UK resident Trustee shareholders.

Before 5 April, RND shareholders were specifically excluded from this charge but that exclusion has now been removed. RND shareholders will now be charged either when such gains are remitted (if the remittance basis applies) and otherwise on an arising basis. If an offshore company realises gains on a UK property, those gains are therefore attributable to RND shareholders on an arising basis.

Rebasing, as described above, only applies to trustees and not section 13 companies owned by individuals. Therefore individuals who become liable for CGT under section 13 can be liable for all gains realised after 5 April even if part of the gain accrued before 5 April. However, trustees who own a section 13 company may apply for rebasing. If an individual’s home is owned by such a company, Principal Private Residence Relief will not be available to exempt any proceeds of sale from CGT in the way that it may be if the home is either owned directly or through a trust. For both these reasons, direct ownership of property by a company is not an attractive option.

## **REMITTANCE BASIS**

The “remittance basis” describes a general rule that RND individuals are only liable to UK tax on overseas income and gains which are brought in (i.e. remitted) to the UK. Those rules have been changed as described follows:

### **Claims for Remittance Basis to Apply**

The remittance basis must now be claimed each year for income and gains as, otherwise, the RND will be taxed on worldwide income and gains on an arising basis. The only exceptions are where an individual’s unremitted foreign income and gains for a tax year are less than £2,000 (where the remittance basis will apply automatically and without loss of any allowances); or where they have no UK income and gains and no relevant foreign income or gains are remitted in that year. Whenever the remittance basis is *claimed*, personal allowances and the CGT annual exemption will be forfeited.

### **Long-Term UK Residence Charge**

If an individual has been resident in the UK for at least seven out of the preceding nine tax years and is over 18, he must now pay a £30,000 charge in order to claim the remittance basis. The rules for this are more complicated than the flat fee originally envisaged, the changes being included to ensure that taxpayers can claim a credit for the charge against foreign tax (although it is not yet clear whether the US tax authorities have accepted this).

RNDs must therefore nominate foreign income and gains for that year, the UK tax on which would be equivalent to £30,000 (after any allowable credits or deductions). If the tax payable on the nominated income and gains is less than £30,000, HMRC will deem income to be nominated to make up the difference (even if no such income exists). Roughly

£75,000 of offshore income or over £150,000 of offshore gains will be needed to justify the £30,000 charge (assuming Income Tax at 40% and CGT at 18%). The £30,000 must be paid direct from offshore - if it is remitted to the UK first that itself will constitute a taxable remittance.

If the nominated income or gains are subsequently remitted, there is no further tax liability on that remittance **BUT** there are anti-avoidance rules so that this "exemption" only applies if the individual has no other unremitted income or gains. The ordering rules deem other unremitted and untaxed income and gains to be remitted before nominated income and gains and so effectively, the £30,000 charge only satisfies the UK tax liability once all untaxed offshore income and gains have been brought in.

Individuals may choose to claim the remittance basis and pay the £30,000 charge for some years but not others. Husbands and wives could, for example, arrange the family finances in such a way that only one of them pays the annual charge each year.

## Meaning of Remittance

The definition of "remittance" has been radically extended in a number of ways:

### *Bringing assets to the UK*

Before 5 April it was generally necessary to bring the actual income or gains into the UK in cash form for there to be a remittance. Since then, if any asset derived from the offshore income or gains (for instance cars, paintings, yachts) is brought to the UK, this will be a taxable remittance (up to the value of the income and gains) unless:

(a) one of the following exemptions applies:

- Assets which meet the public access rule i.e. certain works of art, collector's items and antiques which are available for public access at a museum or gallery either for a single period of no more than 2 years or for a longer period agreed with HMRC
- Clothing, footwear, jewellery and watches brought into the UK for **personal use** i.e. owned by a "relevant person" (see below) and for use by a relevant person (other than a trust or company)
- Assets worth less than £1,000
- Assets in the UK temporarily – 275 days per year or less
- Assets in the UK for repair or restoration
- Assets already owned at 11 March 2008 (even if brought in afterwards)
- Assets already in the UK at 5 April 2008; and

(b) with the exception of public access items; the asset is derived from foreign **income** (not if it is derived from gains).

It is important to note that when an exemption expires or the property is sold in the UK, the asset is treated as being remitted at that time. Therefore if an individual does not need the property or proceeds in the UK, it would be better to take it out of the UK before it is sold or before an exemption expires.

### *Payment for UK services*

If untaxed foreign income or gains (or property derived from them) are used to pay for services provided in the UK, this will constitute a taxable remittance. This provision was intended to prevent RNDs paying for UK personal services (such as cleaners, nannies etc) from unremitted income but in its original form would also have caught many UK financial institutions and advisors on offshore matters. There is now therefore a limited exemption: where the service relates wholly or mainly to property situated outside the UK and the payment is made to an offshore bank account of the service provider there will be no remittance. However, the exemption does not apply where the UK service relates to the provision in the UK of a benefit that is treated as deriving from income or gains under various anti-avoidance provisions and it is not yet clear how all of this is going to work in practice.

### *Offshore Mortgages*

The use of untaxed foreign income or gains (or property derived from them) outside the UK to service a debt relating to UK property or services (whether secured directly on the property or by guarantee) will constitute a remittance. However

there is an exemption where **untaxed foreign income** is used to pay the interest on an offshore mortgage which existed **before** 12 March 2008. This exemption will last until 5 April 2028 or until the loan terms are varied, if sooner.

#### *Remittance for the Benefit of a Relevant Person*

Before 5 April it was generally possible for an individual to give money away to a family member and for the recipient to bring it into the UK without there being a taxable remittance. This practice has now been curtailed, although not as severely as the original proposals suggested. From 6 April, when untaxed foreign income and gains (or property derived from them) is brought to, received, used in the UK, or used to pay for services provided in the UK **by or for the benefit of a relevant person**, this will be a taxable remittance by the donor. These restrictions apply equally when the individual makes a gift to another person (not a relevant person) which is then brought to the UK and enjoyed by the donor or a relevant person. Although the extended remittance rules described above apply to individuals whenever the income or gains arose (subject to the exemptions described above) they only apply to other relevant persons in respect of income or gains which arose after 5 April.

A "Relevant Person" is: an individual; their spouse, co-habitee or civil partner; a child or grandchild under 18 of any of the above; a close company (or one which would have been close if UK resident) in which any of the above is a participator; the trustees of a settlement of which any of the above persons is a beneficiary; or a body connected with such a settlement (e.g. company or sub-fund). This definition is narrower than that originally proposed and the exclusion of adult children and grandchildren is a welcome concession. It is still therefore perfectly possible to make genuine gifts overseas from untaxed income or gains to adult children who bring the gift into the UK without incurring a tax charge. However, if an individual gives cash to his adult children, which they then use to buy a house in the UK for him to live in, this will be a remittance.

#### *Gifts to Trusts*

If an individual transfers an asset standing at a gain to a trust after 5 April and the trust later makes a capital payment to any person in the UK, the Settlor will be taxed on that original gain. Therefore, from now on, it is preferable not to settle assets pregnant with gains into an offshore trust if payments are in future likely to be made to beneficiaries in the UK. Further, because a trust may be within the definition of "relevant person", gifts of income to a trust should also be avoided: they may also give rise to taxable remittances, if the trust subsequently brings funds in to the UK.

### **Source Ceasing**

Prior to 6 April, an RND could not be taxed on a remittance from a source of income that had ceased. If, therefore, he received income from a bank account and that account was then closed, he could remit that income to the UK tax free. From 6 April this is no longer possible.

### **Mixed Funds**

There are new statutory rules to determine the order in which different types of income and gains are remitted where they have been mixed in a single bank account. An important effect of these is that, if a capital sum contains both pure capital and gains (as is often the case), gains (which are taxable) will be treated as remitted first, before the (non-taxable) capital. There is also an anti-avoidance provision which prevents the identification rules applying, if they have been used advantageously in a tax planning arrangement.

It is now more important than ever to keep separate accounts for different sorts of income and capital (where possible) so that RNDs can choose the order of remittance.

### **Temporary Non-Residence**

From 6 April, if an RND who has been resident for four out of seven tax years leaves the UK but returns within five tax years and, in the intervening period has remitted income accrued before his departure, this will be a taxable remittance upon his return. This brings the rules for income in line with those that already applied for capital gains.

### **Foreign Losses**

Before 5 April, RNDs received no CGT relief for losses arising offshore on the disposal of non-UK assets. Now, however, RNDs taxable on an arising basis will get automatic relief for foreign losses and an RND who claims the remittance basis can make an irrevocable election for all foreign losses to become allowable in subsequent years when they are taxed on

an arising basis. This is a potentially useful planning tool and it will be important to realise gains and losses at the right times. There are, though, some disadvantages - in particular, all RND's must disclose details of unremitted capital gains to HMRC and losses have to be used in a particular order.

## CHANGES TO RESIDENCE TEST RULES

The law for determining a person's residence status is in many respects unsatisfactory in that it comprises a mixture of both statutory and non-statutory rules. There have recently been calls from the professions for a full statutory code and this is something which the government is considering.

Meanwhile, HMRC booklet 'IR20' continues to contain the essential guidance and this has just been updated to reflect the Finance Act changes. The main change is that, for the purpose of the statutory day-count test (and, according to IR20, the non-statutory day-count test also) an individual is only treated as spending a day in the UK if he or she is present in the UK at the end of the day (i.e. at midnight). The test is now based on nights, rather than days, spent in the UK and there are various exceptions for passengers in transit, etc.

## CONCLUSION

In relation to offshore trusts, although the position of RNDs is less advantageous than it was before, they are still in a better position than other residents. RNDs are not subject to the Settlor charge and there will be no CGT liability unless benefits are received in UK. Judicious use of rebasing and the new matching rules may also offer opportunities to reduce drastically any potential UK CGT bill. The IHT benefits of offshore trusts may well still outweigh any CGT disadvantages and they may also become a useful tool in structuring a family's affairs to minimise payment of the £30,000 charge.

The biggest challenge for RNDs is likely to be the extended remittance rules. The new rules are very wide and, even though they are at last in the final form, it is still not yet clear how they will work in practice and many questions remain - we anticipate that HMRC will issue more detailed guidance in the coming year. We will keep you posted on any new interpretations and developments through our regular newsletters but, in the meantime, if you are affected by any of the above issues please do contact your usual Boodle Hatfield advisor or one of the contacts below.

**July 2008**

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## PRIVATE CLIENT AND TAX CONTACTS

This document is intended to provide a first point of reference for current developments in aspects of tax law. It should not be relied on as a substitute for professional advice. If advice on a particular circumstance is required please contact your Boodle Hatfield lawyer or one of the contacts listed below:

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