TAXATION
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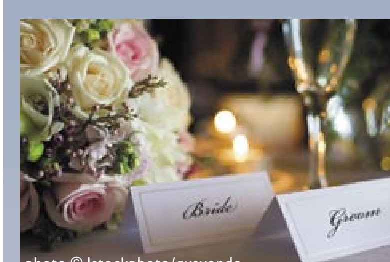

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Alien entanglements

Even for non-domiciliaries with quite straightforward financial affairs, the new remittance rules are monstrously complicated and opaque, warns SIMON MCKIE.

Finance Act 2008, Sch 7 introduces the new remittance basis rules. For the first time that the author can recall, the Government published a substantial tranche of new legislation in the Finance Bill of fundamental importance to the UK economy affecting a large group of taxpayers which it acknowledged at the time of publication to be inadequate and to require substantial revision. The legislation runs to seventy-one pages, and even for taxpayers with quite straightforward affairs it is monstrously complex and opaque.

By way of a demonstration, this article challenges readers to test the new provisions by applying them to the example of a non-domiciliary whose affairs, by comparison to many, are quite simple; he has interests in property in only two countries and in only three classes of assets. The rest of this article takes the reader briefly through the steps which he must take in making the computation, though not giving all the answers. The *Taxation* website, www.Taxation.co.uk, contains a much fuller version of this article setting out the detailed computation – why not calculate Caspian's UK taxation liability for 2008-09 yourself and then go the website to see if we agree? In any event, the reader who follows the calculation of Caspian's liability under the new rules to its end will certainly deserve to reward himself with a large glass of best Somersetshire cider.

Caspian and his domicile

Caspian's circumstances are set out in the ***Example*** on the following page. He is domiciled in Narnia. Narnia charges income tax on all Narnian source income and gains except on the interest income of non-residents. Capital gains are charged at 16%. Narnia's general income tax rate is a flat 18% on income above the sterling equivalent of £6,000.

Narnia has a double taxation treaty with the UK conforming to the OECD model treaty, (adopting the credit method under Article 23B) except that under the Narnian treaty a contracting state may tax capital gains arising in respect of any assets situated in that state and the other contracting state must give credit for that tax. Under the treaty, rent on Narnian property, dividends from Narnian companies and Narnian source interest may be taxed in Narnia. Except in the case of holdings in Narnian companies of 25% or more (which Caspian

KEY POINTS

- The new remittance basis – complex and opaque?
- A practical example.
- The capital payments charge.
- Computing the liability on remitted income and gains.
- Don't overlook deemed remittances.

does not own), the double tax treaty restricts Narnian tax on dividends paid to a UK resident to 15% and Narnian tax on interest paid to a UK resident to 10%.

Which charges?

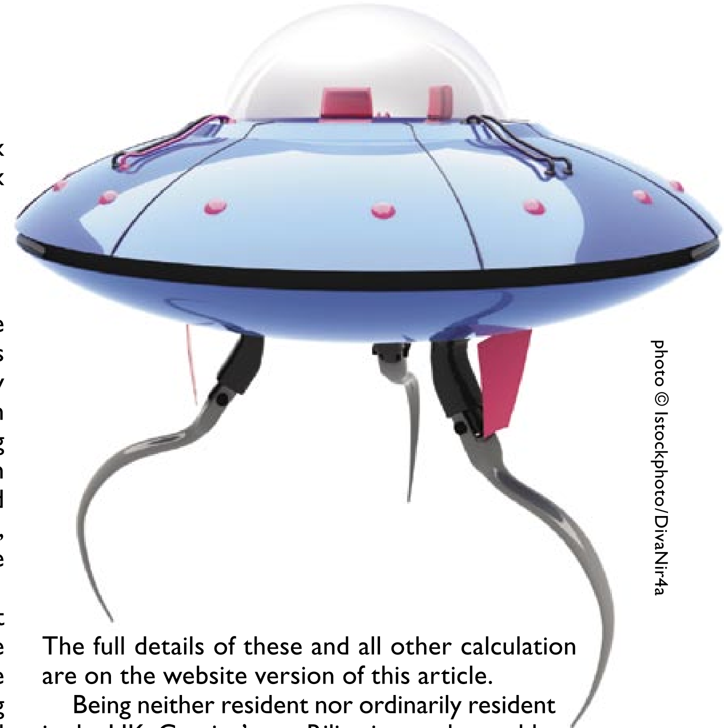
Because Caspian had not set up the Caspian Trust (see ***Example***) by reference to UK taxation, the transfer of assets abroad provisions in ITA 2007, Part 13, Ch 2, does not apply to its income. The trustees had the power to benefit Caspian under the terms of the Caspian Trust so the income arising under the settlement is treated as the income of Caspian under ITTOIA 2005 s 624. Because Caspian is not domiciled in a country of the UK in any relevant tax year, TCGA 1992, s 86 (the 'offshore settlor charge') will not apply to the settlement in any relevant year (TCGA 1992, s 86(1)).

TCGA 1992, s 87, however, has applied to the settlement since 1998-99 when s 87(1) was amended. But until the changes made by the FA 2008, Sch 7 came into effect, the application of s 87 did not result in any gains becoming chargeable because only Caspian had received capital payments under the settlement and s 87(7) provided that a beneficiary was not to be charged to tax on chargeable gains treated under the capital payments charge as accruing to him in any year unless he was domiciled in the UK at some time in that year. However, FA 2008, Sch 7 repeals the previous s 87 and inserts a new s 87C and new s 90 and amends various other relevant sections of TCGA 1992. It is not entirely clear that these amendments do not create charges in relation to 2007-08 and previous years, but HMRC claim that they do not do so and in applying them to the example in this article we shall assume that they are correct.

Settlement gains and income

The first step is to determine the TCGA 1992, s 2(2) amounts for each tax year of the settlement and the capital payments received by beneficiaries of the settlement.

Where, as here, TCGA 1992, ss 87 and 89(2) applied to a settlement for the tax year 2007-08 or any earlier year, FA 2008, Sch 7 para 120 applies to the settlement to determine the s 2(2) amounts for the settlement for 2007-08 and previous years. So one applies the five-step process set out in that section. Then one applies the matching rules of TCGA 1992, s 87A(2). That is another five-step process.



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The full details of these and all other calculation are on the website version of this article.

Being neither resident nor ordinarily resident in the UK, Caspian's son Rilian is not chargeable to capital gains tax on any gains treated as accruing to him. Caspian is chargeable on any gains treated as accruing to him, but he is assessable on the remittance basis so we now have to apply the remittance basis to these gains. New ITA 2007, s 809L provides the rules for determining remittances. Surprisingly, for reasons given on the website, it appears that no gains have been remitted – can you work out why?

The income of the settlement has been segregated outside the UK and has not been used in any way in relation to purchases of assets, the provision of services or in respect of a debt. Therefore, it does not fulfil either condition (A) or condition (B) in ITA 2007, s 809L(2) and (3) and has not been remitted to the UK.

Personal income and gains

New ITA 2007, s 809Q(6) defines a mixed fund as:

'… money or other property which immediately before the transfer, contains or derives from:

(a) more than one of the kinds of income and capital mentioned in sub-section (4) [ibid]; or
(b income or capital from more than one tax year.'

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Example. Caspian

Caspian has been resident and ordinarily resident in the UK since 1985-86. Already a successful business man, when he took up residence in the UK he set up a financial company (Dawn Treader Enterprises Ltd), with offices in the City of London. The company is incorporated in the Isle of Man, but is resident in the UK for tax purposes. It pays no dividends, retaining its trading profits.

Before taking up residence in the UK and without reference to UK taxation, Caspian had settled money and shares (the 'Caspian Trust') on trustees resident in the Island of Romandu which is a tax haven. The trustees have a wide discretion to benefit any one or more of the class of beneficial objects and Caspian is a member of that class. The trustees have established two bank accounts in Romandu; one for income and the other for capital. Romandu does not impose any direct taxes and has no double tax treaties.

On 6 April 2005, the trustees made a loan (interest-free and repayable on demand) to Caspian of £500,000. The moneys were transferred from the trustees' capital bank account to Caspian's UK bank account. This loan remains outstanding. The market rate of interest which would have been paid on an equivalent loan from a commercial lender is 5% in all relevant periods. Caspian's loan is secured on his UK residence.

The assets in the settlement and the annual income which arises in respect of them as at 6 April 2008 are as follows.

Settlement assets	*Market value £000*	*Income £000*	*Rate of foreign tax %*
Various Narnia shares	2,000	60	15
Capital bank account	1,200	60	0
Income account	900	45	0
Loan to Caspian	500	0	N/A
Total	4,600	165	

The trustees have made the following capital gains over the life of the trust.

Year	*Trust gains (£000)*
2000-01	200
2007-08	200
2008-09	1,000

The gains in 2008-09 arose on disposals of Narnian shares which took place on 30 April 2008 resulting in total proceeds with a sterling equivalent of £1,200,000. The entire gain arose from an increase in value which took place after 5 April 2008.

Caspian's personal assets with their market values and the annual income to which they give rise are as follows.

Personal assets	*Capital value £000*	*Income £000*	*Rate of foreign tax %*
UK residence	4,000	0	N/A
Shares in Dawn Treader Enterprises Ltd	20,000	0	N/A
UK bank accounts	100	5	N/A
Narnian shares	3,000	90	15
Narnian real property	4,000	280	18
Narnian original capital bank account	500	25	0
Narnian accumulated income account	900	45	0
Narnian capital proceeds account	700	35	0
Total	33,200	480	

On 30 April 2008, Caspian sold a number of Narnian shares giving rise to proceeds of £1,500,000 and gains of £1,000,000. Due to an error in his instructions to his bankers, the proceeds were paid into his Narnian original capital bank account rather than the Narnian capital proceeds bank account. Unaware of this, on 1 May 2008 he transferred £500,000 from his Narnian original capital bank account to his UK account from which he made a short term loan to a fledgling UK resident trading company ('Enterprise Ltd') of which he was a controlling shareholder. This loan was repaid on 31 March 2009 and the repayment was made directly to his Narnian original capital bank account.

On 5 October 2008, the trustees lent Caspian's son, Rilian (who was born on 6 April 1991 and who had never lived in the UK) £250,000 to fund the acquisition of an apartment in the UK in which Rilian intended to stay on his annual visits to the UK of four to six weeks a year in aggregate. The trustees transferred the cash from their capital bank account.

In completing Caspian's taxation return for 2008-09, his accountant discovered the error in relation to the banking of the proceeds of Caspian's disposal on 30 April 2008. On his accountant's recommendation, Caspian elected for the remittance basis charge to apply for 2008-09 and nominated £166,000 of the capital gains arising on his disposal of shares on the 30 April 2008 as being gains to which new ITA 2007, s 809G(2) was to apply. In this way the accountant hoped that the remittance basis charge would be franked by the foreign tax credit in respect of Narnian tax charged on Caspian's disposal and Caspian's UK tax liability would be £11,000 ((£500,000 @ (18% – 16%)) + (£5,000 @ 20%).

There is a strange circularity in this definition. In order to know whether a fund is a mixed fund you must know whether it contains, or derives from, the various sorts of income set out in s 809Q(4). One determines the composition of the fund from ITA 2007, s 809R. That section, however, only applies for the purposes of Step 1 in new ITA 2007, s 809Q(3). In turn, the application of new s 809Q is determined from whether various circumstances involving mixed funds exist.

To make sense of the provisions one has to cut the circle somewhere. So we start by assuming that Caspian's Narnian original capital bank account was a mixed fund and then applying the various provisions of s 809R to determine of what that mixed fund was composed and of s 809Q to determine what has been transferred from those funds.

Under ITA 2007, s 809X property which is brought to, or received or used in, the UK in circumstances in which s 809L(2)(a) applies (the first limb of condition (A) for determining a remittance) is to be treated as not remitted to the UK if it is exempt property. So one then has to consider whether or not the money transferred from the Narnian original capital bank account was exempt property. Check your answer against mine on the website.

> "*To make sense of the provisions one has to cut the circle somewhere.*"

Like the trust income, all of Caspian's relevant foreign income for the year which arose on his personal assets had been segregated in his Narnian accumulated income account and had remained outside the UK. It had not been dealt with in any way which satisfied any of the remittance conditions (A) to (D) set out in ITA 2007, s 809L. So none of this income had been remitted.

Deemed remittances

Having determined what income and gains Caspian actually remitted, one then has to consider the deemed remittance rules of ITA 2007, ss 809I and 809J.

Where s 809I applies:

> 'Income tax and capital gains tax are charged, for that year and subsequent tax years, as if the income and chargeable gains treated under [new s 809J] as remitted to the United Kingdom by the individual in that tax year had been so remitted (and income and chargeable gains of the individual that were actually remitted in that tax year had not been).'

So, where s 809I applies, the actual remittances of income and gains determined under the complex remittance rules of new s 809L to s 809S are ignored except to the extent of determining the total remittances and the income and gains treated as remitted are identified under s 809J.

The computation is made simpler by the fact that this is the first year to which the new rules apply. Part of Caspian's nominated income and gains have been remitted to the UK in 2008-09 and the only part of the remittance basis income and gains which has been remitted to the United Kingdom is that part of the personal gains which has not been nominated. The conditions for s 809I to apply, therefore, are satisfied.

The deemed remittances under s 809J are then identified through yet another multi-step process.

Having done that, one is in a position to calculate Caspian's income tax and capital gains tax self-assessment for the year.

New ITA 2007, s 809H(4) treats the taxpayer as having nominated an amount of unspecified income sufficient to give an additional income tax liability equal to the difference between £30,000 and the increase in tax payable due to the income and/or gains assessable under s 809H(2) ibid. The effect of this provision is that where double tax relief is available on the income nominated to be taxed under s 809H(2), the liability will be increased by s 809H(4) by the same amount. It is doubtful whether the Courts would accept that the purpose of the double taxation relief provisions can be defeated in this way, but in the full website version of this article we have applied a literal construction of the legislation.

An unpleasant shock

Caspian's accountant had been expecting a liability of £11,000 ((£500,000 @ (18% – 16%)) plus (£5,000 @ 20%)). After such a hard journey the actual liability, which you will find in the website article, came as something of a shock to him. He had overlooked the deemed remittance rules in New ITA 2007, s 809I and the interaction of s 809H(4) with double tax relief. Caspian had also suffered from the fact that personal and annual capital gains tax allowances are not available when the remittance basis is claimed and the dividend upper rate does not apply to dividend income taxable on the remittance basis.

Don't confuse the customers

Caspian's affairs are simpler than one is likely to find in real life. Our example shows that calculating a tax liability under the new remittance basis rules is extremely complicated. Even so, it skates over a number of uncertainties in the construction of the legislation.

The logic of providing a special privilege to those with weak connections to the UK is to place a price on the privilege of residence here which balances the benefits of residence to the individual non-domicillary against the advantages to this country of his residing here (which we should lose if he were to move to another jurisdiction). The first rule of effective pricing is that one's pricing structure should be understood by one's customers. Otherwise, they will deduct a risk premium from the price they are willing to pay to take account of the risk that they may be charged more than they think. The second rule of effective pricing is not to divert profits away from yourself to third parties by making your pricing structure so complex that the customer has to pay for advice on the best course of action in relation to it. The new remittance basis transgresses both of these rules. We are used to stealth taxes – the Government has given us a stealth dis-incentive. ■

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