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Keeping it clean

Isolating and preserving clean capital are essential undertakings for foreign domiciled individuals and its task easier said than done

Foreign domiciled individuals (non-doms) resident in the UK can elect to be taxed on the remittance basis, instead of being taxed on their worldwide income and gains in the same way as other UK residents. If they claim the remittance basis they remain taxable on their UK income and gains, but their foreign income and gains are only taxable if, and to the extent that, they are used in or brought (remitted) to the UK.

This leaves non-doms with two options to minimise their UK tax liability; either not remitting money to the UK from abroad at all, or ensuring that what they do bring to the UK is something other than foreign income or gains.

Introducing clean capital

For many non-doms, meeting UK living costs without using money from abroad is simply not feasible. The next best solution is to identify money overseas that is, in fact, neither foreign income nor gains. This is called clean capital.

Clean capital has become something of a buzzword recenty, particularly for those in international private banking and wealth management circles. In our experience, the term is used too liberally at times, and it is important to understand exactly what is meant by clean capital from a tax perspective. It can arise from:

1. Inheritance or gifts, normally from a friend or family member; and
2. Foreign income and gains before an individual becomes UK tax resident.

Pre-arrival income and gains do not need to be remitted before moving to the UK. The money retains its tax-free nature provided, it is segregated from any future income or gains.

A potential pitfall

Superficially this sounds simple enough. However it should be borne in mind that gains realised after an individual becomes UK resident are calculated by reference to the cost of the asset when it was originally acquired, which may have been many years ago. There is no automatic uplift in the base cost to the market value of the asset, as at the date of UK arrival.

Consequently there is a one-off opportunity to create clean capital by making foreign gains before becoming UK resident. But care must be taken with the potential tax liability where you are resident when you make the gains. Owning an asset before you become UK resident does not mean that the whole value of the asset can be remitted as clean capital, if it is sold after UK residence starts.

Maintaining clean capital

Identifying clean capital is one thing, but preserving it is quite another. Just because money was once clean capital, this does not mean that it still is. It is necessary to consider how it has been managed.

In theory, if capital is kept separately in one bank account, tax-free remittances from that account are possible, provided the interest earned on that account is credited directly to another account.

This requires the operation of at least two separate accounts i.e. a capital account and an income account. However, more elaborate account structures involving borrowings can be effective for those wishing to invest their clean capital for a return, without it becoming tainted. This requires careful planning and execution.

Regardless of complexity, it is vital that the bank understands how the accounts need to be operated; otherwise capital can easily become tainted by amounts of foreign income and gains arising after UK arrival. This results in a mixed fund.

Consequences of a mixed fund

Once a mixed fund is created, the tax treatment of any future remittance from that account is determined by specific ordering rules. Effectively, a remittance from a mixed fund is deemed to represent any income in the account, in priority to capital gains, and capital gains in priority to clean capital.

It is not possible to 'clean up' a mixed fund simply by transferring an amount equal to the income within it to another offshore account. Specific rules also apply to a so–called offshore transfer, such that it is treated as containing a proportionate element of the income, capital gains and capital within the account balance immediately before the transfer takes place.

The only way to rectify a mixed fund is to remit the income to the UK which, by definition, results in a tax charge. Depending on the value and quantity of the transactions involved, the creation of a mixed fund can be costly for clients. ■

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