Keep it clean

MARK DAVIES and **NICK BERESFORD** explain how the pre-UK residence offshore income and gains of a non-domiciled individual can remain outside of the UK tax net.

Ensuring tax-efficient access to "clean capital" is one of the most important tax matters for a non-UK domiciled individual. The expression "clean capital" signifies that this is money which can be remitted to the UK without tax consequences. Most commonly this will be foreign income and gains that arose before the individual became UK resident, but it can also include outright gifts and monies received by way of inheritance. This should always be considered carefully as part of pre-arrival planning.

By way of overview, UK resident but non-UK domiciled individuals can elect to shelter unremitted foreign source income and gains from UK taxation. This is achieved by electing to be taxed on the remittance basis and, in the case of long-term residents, by paying the applicable charge under this. In other words, such persons are not taxable on their foreign source income and gains unless and until these are remitted to the UK. From 6 April 2017, the taxation of non-UK domiciled persons who have been resident for 15 of the previous 20 tax years is subject to legislation that is due to be enacted in FA 2016, which will limit the use of this basis of assessment.

KEY POINTS

- UK resident but non-UK domiciled individuals can live off their "clean capital" throughout their stay in the UK and not incur tax.
- Clean capital must be appropriately segregated or "ring-fenced" so that it cannot be mixed with foreign income and gains arising after the client becomes tax resident in the UK and be subject to the mixed fund rules.
- Those who are actively trading or investing can use trusts if they are set up correctly.
- Clean capital can be used as security for a bank loan which can be invested offshore in income and capital gains producing assets.
- Offshore investment bonds can preserve access to clean capital and offer other potential benefits.

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Careful planning for clean capital

Subject to careful planning, some UK resident but non-UK domiciled individuals can structure their affairs to live off their clean capital for their entire stay in the UK.

First, pre-arrival planning should focus on quantifying the amount of clean capital the client will require to sustain their lifestyle while tax resident in the UK. Second, clients should structure their affairs appropriately so this clean capital is segregated (or "ring fenced") so that it cannot be mixed with foreign income and gains arising after the client becomes UK tax resident. Knowing when a client becomes tax resident, whether on 6 April in the year of arrival or on the date of arrival under the split-year rules, is imperative.

Mixing clean capital with post-arrival foreign income or gains will create a "mixed fund". Remittances from such funds are subject to the onerous ordering rules in ITA 2007, s 809Q. Broadly, these deem the remittance to be sourced from the most unfavourable component of the fund. In practice, any income in the mixed fund is treated as remitted first (at rates of up to 45%), followed by gains (at rates of up to 28%), and finally clean capital. Further complications arise if there are transfers between a mixed fund and another account. In this case, a proportion of the income, gains and capital are transferred across. This exercise must be repeated annually by reference to the income, gains and capital paid into the mixed fund each year.

Segregating clean capital can be difficult in practice and caution must be taken when structuring clients' affairs to avoid applying the mixed fund rules. Many high net worth clients are not prepared to allow inflation to erode their capital and require the capital to be invested to derive regular income or long-term gains. As a result, segregating clean capital from current income and gains can be especially challenging.

With the above in mind, we have set out below some common "dos and don'ts" regarding clean capital.

Mistaken conversions

Don't mistakenly convert clean capital into foreign income. A common misconception is that the clean capital of an offshore company, such as its retained profits derived before the owner became UK resident, will retain its character when paid out to him after his arrival in the UK. This is not the case.

Distributing clean capital as a dividend after the shareholder becomes UK resident will convert the clean capital into "relevant foreign income" for the year in which the dividend is paid. This will make the dividends taxable if and when they are remitted to the UK, notwithstanding their previous underlying characterisation as clean capital.

If an offshore company's retained profits are expected to be required to meet an individual's living expenses while in the UK, it would be advisable to declare and pay dividends to the shareholder before they become UK tax resident. This will allow the funds to be segregated as clean capital moving forwards.

An alternative may be for the company to make a loan to the client. However, there are tax implications for "relevant debts" once brought to the UK and a tax liability can be incurred on the repayment or servicing of such a loan using foreign income or gains.

Tainting

Don't automatically trust banks to understand the clean capital tax rules. It is common for high net worth, non-UK domiciled individuals to establish ostensibly "segregated" accounts before arriving in the UK. Many banks describe themselves as capable of establishing and maintaining such accounts for non-doms. Some banks, particularly those in the US, may not have the necessary platform to segregate accounts.

We have first-hand and anecdotal experience of many so-called "segregated" account mandates that have tainted clean capital with foreign income or gains, or have not segregated clean capital from the outset. One particularly egregious example was a bank simply naming an account the "clean capital" account and assuming that was the end of the matter as far as ongoing monitoring was concerned. Another common example is a clean capital account that accrues interest which is paid first into that account before being transferred into the separate income account.

We have also encountered banking mandates where interest income was paid into the clean capital account and swept out only on a monthly basis (or less often). In this instance, the capital account becomes a mixed fund and the "sweeping out" of income needs to be treated as an offshore transfer when applying the mixed fund rules.

Best practice suggests that the establishment of banking mandates for high net worth non-domiciles should be carried out with input (and in some cases direct instructions) from suitably qualified UK advisers.

Confused concepts

Don't mix trust accounting and tax concepts. Clients arriving in the UK may have interests in offshore trusts and the offshore trustees may have prepared financial statements with income and capital accounts in accordance with trust law. However, this can make it difficult to identify the clean capital portion of the trust fund once the individual becomes UK resident.

For example, trust income that is not paid out to beneficiaries in the same year is typically appropriated to the trust's capital account. If, for example, a UK-resident beneficiary receives a "capital" distribution that is ultimately sourced from trust income derived after becoming UK tax resident, or if there is relevant income within the structure, the distribution would be taxable on the beneficiary wholly or in part.

Therefore, when a distribution or benefit is received from an offshore structure, it is important to analyse carefully the underlying nature of what the individual receives. There is merit in advisers proactively working with offshore service providers to ensure that financial statements are prepared for tax purposes. This will assist in quantifying any potential UK tax liabilities.

> ***"For clean capital to be properly segregated from income and gains it must actually be segregated into separate accounts."***

No notional segregation

Don't notionally segregate. For clean capital to be properly segregated from income and gains it must *actually* be segregated into separate accounts. We have seen cases of clean capital, income and gains being mixed into a single account and then notionally "segregated" into separate tranches in statements provided to the client.

Unless clean capital is preserved in its own separate account, it will become part of a mixed fund for UK tax purposes.

Client collateral

Don't use foreign income and gains as collateral. A previously common tax planning technique was for a client to use their foreign income and gains as security for a loan before bringing the borrowings into the UK to fund living expenses. HMRC's previous position was that, assuming the loan was on commercial terms and regularly serviced, the borrowed monies would not themselves constitute a remittance of the foreign income and gains when the borrowings were brought into the UK.

However, HMRC reversed their view on this issue on 4 August 2014 and now consider that borrowings brought into the UK that are secured against foreign income and gains will constitute a remittance of the underlying foreign income and gains that are being used as security.

HMRC's announcement (tinyurl.com/p4ay5qz) advised taxpayers that they would take steps to reassess taxpayers who had not unwound these types of lending arrangements by 5 April 2016. Thankfully, HMRC have backed down from this position and stated on 15 October 2015 (tinyurl.com/ofqx2fn) that they do not intend to reassess clients who entered into these types of arrangements before 4 August 2014. This is HMRC's interpretation of the law, which is untested by the courts and leading tax counsel have disagreed with aspects of this. However, it would clearly be unwise to employ these types of loan arrangements moving forwards.

Note that there is nothing to prevent the taxpayer from borrowing against a clean capital account and remitting the borrowings to the UK. But the repayment of the loan will be a potentially taxable event because it is a relevant debt.

Segregate accounts

The first "do" is to operate appropriately segregated accounts because these will help to avoid the complications associated with the mixed fund rules. The aim of account segregation should be to identify distinctly separate accounts where clean capital is deposited, where gains are deposited and where income is deposited. As a suggestion, the following five accounts could be maintained.

- A "clean capital account". A common segregated account structure will start with an account, which will hold cash balances representing foreign income and gains arising before the account holder becomes UK resident. The only funds which would be added to this account after that point would be UK-sourced income (taxed as it arose), inheritances or gifts.
- A "foreign interest account". Interest arising on the clean capital account after arrival in the UK should be paid directly into this.
- A "capital gains account". This can receive the proceeds from the disposal of any foreign investments or assets that have produced a capital gain after arrival.
- A "capital loss account". To receive the proceeds from the disposal of any foreign investments or assets that produce a capital loss after arrival. The loss position would need to be calculated in pounds sterling in accordance with UK capital gains tax principles. Capital gains and losses on investments acquired using foreign income are arguably derived from foreign income and the remittance of such capital gains and losses to the UK may have income tax implications.
- A "foreign income account". This can be used to receive any other overseas income. If necessary, this account could be further segregated into several other accounts, one for each type of income received (say dividends or interest) and by reference to amounts of foreign tax suffered or withheld on that income. This allows for more control over the UK tax implications should a remittance to the UK be required from these accounts.

If possible, remittances should not be made to the UK from the foreign interest, capital gains or foreign income accounts because such payments would be taxable on the client. However, funds can be remitted to the UK generally tax-free from the clean capital and capital loss accounts.

Operating correctly segregated accounts as above can ensure that clean capital is preserved and will avoid the application of the mixed-fund rules. However, clients who want to actively put their clean capital to work in trading or investment activities may require more sophisticated structures such as trusts or loan arrangements as discussed below.

Pre-arrival income and gains

Realise income and gains before arrival. By definition, clean capital refers to income or gains realised before an individual becomes UK tax resident under the statutory residence test.

Therefore, before acquiring UK residency, clients should consider bringing forward the realisation of income and gains where appropriate, particularly if they would not otherwise have enough clean capital to sustain their lifestyle in the UK.

This is especially important from a capital gains tax perspective given that individuals do not receive a "step up" to market value on their chargeable assets when they acquire UK residency – a common misconception.

Another potential planning opportunity is to bring forward the declaration of dividends from associated companies before the recipient becomes UK resident.

In all such cases, care needs to be taken that clients arriving in the UK do not meet any of the criteria for split-year treatment outlined in the statutory residence test. If clients rely on split-year treatment to receive income during a period of non-residence in the year of arrival, the amounts could become taxable if, subsequently, split-year treatment is shown not to apply.

Care also needs to be taken to recognise the tax consequences of transactions in the jurisdiction if the taxpayer was tax resident before acquiring UK residency.

Capital structures

Structure the client's capital. For those who are actively trading or investing, there are several more sophisticated techniques that can be employed to segregate clean capital from foreign income and gains.

Trusts can be advantageous vehicles in this respect and can also achieve estate planning and asset protection objectives. Trusts can allow better segregation of clean capital (particularly from gains) when compared with segregation using personal bank accounts. Further, loan arrangements can be put in place between the settlor and trust or trusts to allow the clean capital to be invested in income and gain-producing assets, while preserving the settlor's access to clean capital. Subject to careful structuring, the client would be able to receive distributions from the clean capital trust and remit these distributions into the UK without triggering a UK tax liability.

It should be noted that tax planning involving trusts for non-UK domiciled individuals is inherently complex and requires consideration of the UK's wider anti-avoidance legislation. Expert advice should always be sought when using these types of structures. Complex provisions can trip up the unwary. The "trustee borrowing" provisions in the capital gains tax legislation are examples of this.

It will also be important to monitor developments in the proposed domicile changes announced in summer budget 2015. These will have implications regarding the use of offshore trusts by non-UK domiciled individuals.

Bank loans

Use bank loans. Clean capital could be used as security for a bank loan; the borrowings can then be invested offshore in income and capital gains producing assets. The resulting foreign income and gains can be used to service the loan, as long as it is kept offshore. While potentially simpler, this can make segregation more difficult for sophisticated clients and may not achieve asset-protection and estate-planning objectives.

Offshore investment bonds

Use offshore investment bonds. These can be an effective way to preserve access to clean capital, as well as offering other potential benefits for non-UK domiciled individuals. If the bond is purchased with clean capital, a withdrawal of up to 5% of the premium paid can be taken each year without triggering a UK tax liability. The 5% allowance is cumulative and can be carried forward to future years. Once 100% of the initial premium is withdrawn, any further withdrawals will generally trigger a UK tax charge.

Offshore bonds are an especially attractive investment wrapper for individuals who expect to stay in the UK only for the short to medium term. Such individuals can purchase the offshore bond on arriving in the UK and the growth will roll up tax-free while they are UK resident. The individual may be able to cash in the entire bond once their UK tax residence status ceases without incurring any UK tax liabilities.

However, it should be noted that there are downsides to using an offshore investment bond. Any gains on encashment are subject to income tax on the arising basis. Claiming the remittance basis does not shelter the gains on encashment of an offshore investment bond.

"There are downsides to using an offshore investment bond."

Conclusion

The segregation of clean capital is one of the most important tax planning issues facing non-UK domiciled individuals who are arriving in the UK. However, it is a technical and practically challenging area for tax advisers and care must be taken. Clients will need to put in place robust account segregation measures, which must be monitored continually. More sophisticated clients who are actively involved in trading or investment activities may require more bespoke trust structures or loan arrangements.

It is crucial that clients seek advice well before becoming resident for UK tax purposes under the statutory residence test. Failure to do this may reduce planning opportunities.

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