

Addressing Recent Changes to the Taxation of Foreign Nationals in the UK. July 2008

Administrative Issues

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- No exceptions

Agenda

Introduction and Overview

Residence

Domicile and Remittances

US Citizens

“Mixed Funds”

Share Plans

Capital Gains Tax

Questions

Introduction

Draft legislation published on January 18, 2008

Further clarification delivered in the budget March 12, 2008.

- Most significant proposed change to residence and domicile rules during the self assessment period
- Due to come into force from April 6, 2008
- Some major changes from initial Pre-Budget Report announced in budget
- Initial Consultation Response March 27, 2008
- Draft Finance Bill and Schedules (including Schedule 7) – June 13, 2008
- Amendments – June/July 2008
- Royal Assent – 3rd Week July 2008 ?
- Practical Implementation – 2008/09

Main Components of Original Pre Budget Report

- Changes to definition of “Residence” – “The day count”
- Changes to tax treatment of Resident Non Domiciliaries (RND’s), the “Remittance Basis”
 - “Shorter” term RND’s – less than 7 years
 - “Longer” term RND’s – more than 7 years
- Changes to address “Anomalies”

Fundamentally no major changes to principles in Pre-Budget Report due to be enacted in Finance Bill 2008.

Residence – The Changes

Old Rules

- Resident in UK if spend more than 183 days in the UK during a UK tax year – “Factual Test”
- If coming to the UK, you intend to spend more than 91 days in the UK each year – “Intention Test”
- If coming to the UK, but on average spend more than 91 days in the UK, then will automatically become resident from the beginning of the 5th tax year – “Factual Test”
- If leaving the UK, need to spend less than 91 days on average in the UK from the date of breaking residence to be regarded as non resident – “Factual Test”

For the purpose of the 91-day test, ignore days of arrival and departure.

Residence – The Changes

New Rules

- New day counting rules; if present in the UK at midnight, that day will be counted as a day of presence in the UK
- Exception for transit passengers traveling via the UK provided they do not engage in activities that are substantially unrelated to their passage
- Still no statutory definition of residence
- 91-day residency test remains HMRC guidance only

Residence – The Impact on Your business

- Frequent visitors to the UK are more likely to become UK resident
- Outbound assignees are less likely to break UK residence
- Short-term business visitor tracking will become even more important
- You may need to review your assignment policies to see the level of home trips that are supported
 - Will these mean assignees remain resident in the UK?

Question #1

Mr. Jones arrives in the UK on Monday at 8AM and leaves on Wednesday at 11PM. He only spends Tuesday working in the London office. How many days of UK residency does he have under the new rules for domestic tax residency purposes?

- 0 days
- 1 day
- 2 days
- 3 days

Domicile – The Changes

- From April 6, 2008, the remittance basis will only be available if claimed via the tax return
- Need to be considered non-domiciled to make this claim!
- The remittance basis will automatically apply to relevant individuals who have unremitted income and gains in a tax year of less than £2,000
- A claim can be made for each tax year independently
- If a claim is not made then the individual will pay tax on his or her world-wide income and gains for the year (arising basis)

Domicile – The Changes

What will it cost to claim the remittance basis?

- Loss of the income tax personal allowance and the capital gains tax annual exempt amount
- Individuals who have been resident in the UK for at least 7 out of the previous 9 years prior, will have to pay £30,000 basis in addition to the loss of personal allowance and annual exemption as detailed above
- The £30,000 charge will not apply to children under 18 years

The £30,000 Charge

- When an individual claims the remittance basis and has been resident in 7 of the last 9 tax years (from the start of the 8th year of residence)
- The charge is per person (including spouses) if claiming remittance basis
- HMRC amended the legislation in an attempt to ensure that where double taxation may arise, the £30,000 charge can be creditable under the treaty networks
- Payable with annual tax liability by January 31st

Question #2

Mrs. Smith arrives in the United Kingdom on March 31, 2001 and leaves on October 21, 2008. Will she be subject to the £30,000 charge in order to claim the remittance basis of taxation in the 2008/09 UK tax year?

- No, as she has left the UK before end of tax year
- No, as she only becomes subject in the year following her 7th anniversary
- Yes, as she is resident in the UK on April 6, 2008
- Yes, as she has been resident in the UK in part or in full for 7 complete UK tax years before 5 April 2008

Example 1 – Taxpayer is resident and ordinarily resident for at least 7 out of 9 years

- Annual offshore interest income £180,000
 - Non-US national
 - Tax bill on other investment income if claim remittance basis - £30,000
 - Tax bill on offshore investment income if taxed on arising basis - £180,000-£5,225 x 40% -£69,910 (2007/08 tax rates)
 - Conclusion – Pay £30,000 charge
- Annual offshore interest income £40,000
 - Non-US national
 - Tax bill on other investment income if claim remittance basis - £30,000
 - Tax bill on offshore investment income if taxed on arising basis - £40,000-£5,225 x 40% -£13,910 (2007/08 tax rates)
 - Conclusion – Report and tax all offshore income

Example 2 – Taxpayer is resident but not ordinarily resident, and spent less than 7 out of 9 years in the UK

- Employment income relating to overseas duties £100,000
 - Non-US national
 - Remittance basis – cost is loss of personal allowance - $£5,225 \times 40\%$ i.e. £2,090
 - If taxed on arising basis – cost is $£100,000 @ 40\%$ i.e. £40,000
 - Claim remittance basis
- Employment income relating to overseas duties £4,000
 - Non-US national
 - Remittance basis – cost is loss of personal allowance - $£5,225 \times 40\%$ i.e. £2,090
 - If taxed on arising basis – cost is $£4,000 @ 40\%$ i.e. £1,600
 - Do not claim remittance basis

Impact of Proposed Changes for US Citizens and Companies

US Citizens

The law is being rewritten so that the £30,000 will be regarded as a tax charge on unremitted income and gains, and as such it is more likely to be creditable for the purposes of double taxation agreements.

However, the following conditions must be met to be creditable for the US:

- Must be compulsory
- Must be likely to reach “net gain”, meaning:
 - Must be imposed on income;
 - Be calculated on actual receipts;
 - Be computed by permitting costs to be deductible
- Must not result in the taxpayer receiving a specific economic benefit

The UK has made further amendments to ensure that the charge is “nominated” against specific income to assist in creditability discussions.

Still not clear if creditable for the US as the IRS has not yet commented on the draft legislation.

US Nationals and Greencard Holders

- Taxation on worldwide income in the USA
- Prevention of double taxation by utilizing foreign tax credits
- However individual facts and circumstances and the form of income received may impact on decision to elect “arising” vs. “remittance” basis of taxation post April 6, 2008

| Country | Interest | Ordinary Dividends | Qualifying Dividends | Short Term Cap Gains | Long Term Cap Gains | Rental Income |
|---------|----------|--------------------|----------------------|----------------------|---------------------|---------------|
| UK | 40% | 32.5% | 32.5% | 18% | 18% | 40% |
| USA | 35% | 35% | 15% | 35% | 15% | 35% |

The above is a comparison of the maximum UK and US Federal tax rates applicable to income that could be taxable in the UK on the remittance / arising basis.

Discussion – Considerations for US nationals and US employers on what the new rules may mean in practice in respect to certain common US investment vehicles and structures.

UK Treatment of US Investments

LLC and S Corps

- Partnerships for US purposes but companies for UK
- UK won't give credit for underlying tax

US Municipal Bonds

- UK taxable but US exempt

US Mutual Funds

- Probably subject to UK offshore income gain regime, therefore mismatch of UK/US treatment

UK Treatment of US Investments

US Brokerage Accounts

- US institutions not geared up to provide data on UK fiscal year basis

US Partnerships

- Different rules for calculating and reporting partnership income, expense, basis etc.
- Different year-ends e.g. partnership investment income must be reported on a fiscal year basis for UK purposes.

US IRC S.529 Plans

- UK treatment unclear, but growth unlikely to be tax exempt, therefore UK/US mismatch likely

US Trusts

Grantor trusts likely to be a common issue

- Not clear whether they are trusts for UK purposes
- Will depend on specific facts (e.g. examination of trust deed required)
- UK treatment may mirror US (ideally)
- If not, could be mismatch in timing of tax liabilities, difficulties in applying resourcing provisions and even (worst case) double taxation with no credit relief

Charitable Contributions

- Contributions to US charities not deductible for UK purposes
- Possible solution: dual-qualified charities

Question #3

Would US municipal bond interest be subject to UK taxation on a US national, UK resident who elects to be treated on the arising basis of taxation?

- No, as it is not UK source investment income
- No, as it is not subject to tax for federal purposes in the US
- Yes, but as a specific treaty tax rate of 15%
- Yes, at 40% tax rate for a higher rate taxpayer

Domicile – The Impact on Your Business

- As a business, are you going to reimburse affected individuals for the cost of the £30,000 charge, the loss of the income tax personal allowance and capital gains tax annual exemption?
- If so are you prepared and have you budgeted for these additional costs as an organisation?
- Has the impact of the changes been taken into account in your tax equalization/protection policy? Do you need to review your assignment policies to take account of the new changes?
- Will it become more difficult to localize employees?

Domicile – The Impact on Your Business

- Will your non-domiciled local employee need more assistance with their tax returns?
- Who makes the final decision on if the election in any given tax year is beneficial for your equalized assignees? The business or the individual? Do you feel able to mandate an election on his personal tax return which may impact your company's cost?
- Do you have individuals who are currently on dual contract arrangements? If so, are these still beneficial post April 5, 2008? To benefit from a dual contract, individuals who have been resident in the UK for more than 7 years will have to pay the £30,000 charge.
- Getting UK tax year investment information for assignee tax returns will be very difficult if the remittance basis is not claimed, as most countries report their annual statements on a calendar year basis and not the UK fiscal year – April 6, 2008 to April 5, 2009.

Mixed Funds

“Mixed funds”

- A “mixed fund” is an account which contains differing types of income, e.g. employment income, investment income and capital gains
- As cash is deemed to be fungible, then “source” is difficult to identify and the account or fund is deemed to have become fixed
- Previously, treatment has been based on HMRC practice and some case law as to what “source” of income has to be remitted first
- HMRC announced that further guidance will be coming out in respect of mixed funds legislation and the identification of source rules following consultation. There will be much more detail. However the legislation as it currently stands (July 17, 2008) is unlikely to change before Royal Assent
- A Joint Committee between the ICAEW and HMRC is being set up to review the practical implementation of Schedule 7 to ensure the intentions of the government are reflected in the implementation of the law
- Personal effects under a value of £1,000 will not be regarded as a remittance if brought into the UK

New Rules on Allocating Remittances from “Mixed Funds”

- For transfers / remittances to the UK, the funds transferred are not a pro-rata portion, instead they are made in the following order (simplified slightly)
 - Current year employment income not subject to a foreign tax and taxed in the UK on the arising basis
 - Current year employment income taxed in the UK on the remittance basis and not subject to a foreign tax
 - Current year overseas investment income not subject to a foreign tax
 - Current year overseas chargeable gains not subject to a foreign tax
 - Current year employment income subject to a foreign tax
 - Current year overseas investment income subject to a foreign tax
 - Current year overseas chargeable gains subject to a foreign tax
 - Other current year income or capital
 - Prior year income / gains in the same order

New Rules on Allocating Remittances from “Mixed Funds”

- Where income / gains / capital from different sources or tax years have been paid into the same account overseas, this will constitute a “mixed fund”
- Therefore there is the risk that the payment of an employees salary into an overseas account will immediately create a “mixed fund”
- Previous HMRC practice was to:
 - treat remittances as being first out of income and gains taxable on the arising basis, then out of income / gains taxable on the remittance basis
 - look at the credits / debits on an annual basis
- New statutory tests are more formula driven and will involve more analysis by taxpayers and their advisers
- For transfers to another overseas account, the funds transferred are a pro-rata portion of all of the funds in the first account at that time

Mixed Funds – The Impact on Your Business

- It is essential for assignees to the United Kingdom to order their investment structures accordingly in order to avoid a remittance of a “mixed fund” prior to arrival.
 - Are your systems robust enough to ensure assignees are contacted by the UK prior to arriving here?
 - Where there is an inadvertent remittance by an assignee, will you equalize them on this tax charge?
 - Will you recommend or mandate “source ceasing” at the end of each UK tax year to ensure that funds are appropriately segregated?

Taxation of Share Plans

Finance Bill 2008 – Impact on Share Plans

- Finance Bill 2008 has sought to clarify some specific areas of the taxation of share options and awards
- Some anomalies in respect of the UK taxation of share options, have been addressed – specifically, the “mismatch” in treatment between R/NOR and R/OR individuals in the UK
- Independently of the Finance Bill 2008, recent clarifications have been made with regard to the taxation of awards earned while non-resident in the UK

Taxation of Share Plans

Pre 6 April 2008 position: unapproved options: RNOR option grantee

- Option grant: Income tax on option value
- Option exercise: Income tax via interest-free loan rules during share ownership period
Deemed loan amount = “exercise gain” i.e. usually market value of shares on exercise less amount employee pays for shares in some circumstances, deemed loan amount is reduced by overseas workday relief
- Sale of shares: Income tax on deemed loan amount (treated as loan write-off)
CGT where applicable
If option exercise occurs in a year of non residence and no UK duties, normally exercise and share sale do not trigger income tax

Taxation of Share Plans

Unapproved options: RNOR option grantee after April 5, 2008

Option grant: Possibly wholly income tax exempt (even if exercise price < market value of shares)

Option exercise: Income tax on “exercise gain” – i.e. broadly market value of shares on exercise less amount employee pays for shares

Possibly some form of relief for overseas duties

Sale of shares: CGT where applicable

NB:

- Income tax on exercise even if in a year of non residence and no UK duties
- Consider double tax treaty position

Taxation of Share Plans

Unapproved options: option granted (UK non resident) and exercised as a UK resident after April 5, 2008

Option grant: No UK tax consequences as not UK resident

Option exercise: No UK income tax charge on exercise

Sale of shares: Potential CGT charge on sale if UK Resident, depending on situs of share and remittance.

NB:

- Applies only if option not granted in anticipation of UK employment
- HMRC confirmed (4th July) that will apply if option granted in non resident portion of a UK tax year where employee establishes UK residence (ESC A11)

Question #4

Harry is granted stock options in ABC Inc. on May 20, 2008 while he is a UK non-resident. He establishes UK residence on October 31, 2008 and exercises his option on May 31, 2009 while Resident/Not Ordinarily Resident. He sells the shares June 2009. What are the tax consequences?

- UK income tax on exercise as he is UK resident at that point
- UK income tax on exercise as granted the option during a UK tax year in which he became resident
- UK capital gains tax as resident in the UK at the point of sale
- UK capital gains tax on remittance basis on sale as granted option as a non resident

Taxation of Share Plans

New Proposals

- Relevant to internationally mobile employees who participate in share plans
- Extend to RNORs (but probably not to NRs working in the UK) some tax rules that currently apply only to RORs
- Expect changes to apply to awards made after April 5, 2008
- Parallel regimes for a time
- Check status going forward of any existing agreements with HMRC

Capital Gains Tax Changes

Capital Gains Tax – The Changes

Simple new rules...

- Flat rate of 18% introduced from April 6, 2008
- Taper relief and indexation abolished
- Entrepreneurs relief introduced

Capital Gains Tax – The Changes

The Winners

- Holders of non-business assets
- Approved option holders
- Short-term capital gains

The Losers

- Holders of fully tapered business assets
- Business owners
- Holders of assets with high indexation

Capital Gains Tax – The Impact on Your Business

- Employee booklets, tax notes, communications, etc., may need to be updated
- Changes make HMRC approved company share option plans more attractive as they will be able to benefit from the 18% CGT rate, even if the shares are sold immediately
- Foreign nationals selling offshore property may now be caught! e.g. sale of holiday home or former residence!

Q&A

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