

Changes to the UK taxation of non-domiciliaries

A Guest Article by Ivan Sopher & Co.
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Background

In the Pre-Budget Report of 9 October 2007 the Chancellor, Alistair Darling, announced the introduction of the long-rumoured changes to the taxation of individuals who are resident in the UK but not domiciled here. The initial proposals, introduced in the draft Finance Bill 2008, were sufficiently severe to make many non-domiciled individuals consider moving away from the UK.

Following representations to the Government, the changes introduced in the Finance Bill 2008 have been moderated to lessen their impact. These changes all took effect on 6 April 2008.

It should be noted that at the time of writing the legislation is still in its formative stages, and there are likely to be further changes over the coming months.

Subject to the £30,000 annual charge discussed below, individuals who are not domiciled in the UK do not need to pay tax on income or gains arising outside the UK unless the income or gains are remitted to the UK. To benefit from this treatment an individual has to:

- complete the "Non-residence" pages of his tax return to claim non-domiciliary status
- make a claim for the remittance basis to apply to his overseas income.

An individual's domicile is not necessarily his country of birth, or where he is residing at any particular time. Broadly, it is where he considers his permanent home to be; where he belongs.

- An individual begins life with a domicile of origin, which is normally his father's domicile at the time he is born.
- This can be changed to a domicile of dependency if his father changes his domicile while the individual is under the age of 16.
- Lastly, an individual can obtain a domicile of choice by permanently moving to another territory.

For UK income tax and capital gains tax (CGT) purposes, the period of residence in the UK is immaterial in determining domicile.

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This article describes the main rule changes as of September 2008, under the following main headings:

- £30,000 annual charge
- Capital
- Cessation of source
- Bringing assets into the UK
- Capital losses
- Offshore structures
- Gifts
- Buying a UK home
- Inheritance tax
- The future.

£30,000 annual charge

The first change in the rules is to introduce a tax charge of £30,000 per annum payable by individuals who wish to claim the remittance basis. Originally this was introduced as a fee payable in order to access the remittance basis. This has now been re-categorised as a tax payment on unremitted overseas income. This change has been made so that the taxpayer may be able to claim credit for the £30,000 payment against his overseas tax liability.

The £30,000 tax charge will apply to all non-domiciled individuals who have been resident in the UK for seven out of the last nine years, and will be payable as part of that individual's normal self-assessment.

For example, an individual who became resident in the UK on 1 January 2002 will have been in the UK for more than seven years on 6 April 2008. If his overseas income and gains exceed £2,000 for the year 2008/09, he will have to either pay tax on his worldwide income and gains for that year, or pay the £30,000 tax charge.

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Choice of treatments

In the event that the individual pays the £30,000 tax charge, he will have the choice of treating the payment as income tax or capital gains tax, or a mixture of both. The unremitted income or gains on which the tax is paid will not be taxed again if and when it is remitted to the UK.

On the basis that the individual has both offshore income and gains, it will be more advantageous for the tax to be categorised as being made out of gains. This is because from April 2008 CGT is charged at a maximum rate of 18%, so that a payment of £30,000 made out of gains equates to a gain of £166,000, which would in future enable the individual to remit up to £166,000 to the UK out of these offshore gains. This compares with gross income of £75,000 for a 40% income tax payer.

Unremitted foreign income or gains will be treated as remitted to the UK before income or gains on which the £30,000 has been paid, so access to these latter funds in the UK will probably require further remittances on which UK tax will be payable, first.

It will be necessary for the individual to keep a record of his overseas income and gains as well as the amounts remitted to the UK so that it can be established whether taxable income or gains or funds on which the £30,000 has been paid have been remitted to the UK. This may well mean that an individual who has substantial offshore income or gains will never actually be in a position to remit the income or gains on which the £30,000 has been paid.

Example

- Robert, who is not domiciled in the UK, receives a gift from his father during 2008/09. He places this on deposit and receives bank interest of £70,000 for the year 2008/09, and £200,000 per year thereafter. His UK source income is £300,000 per annum, and he pays tax at 40% in the UK. He remits income of £50,000 in 2009/10, and a further £150,000 in 2010/11.
- For 2008/09 his overseas income is £70,000, so it is beneficial for him to pay tax of £28,000 on the arising basis.
- For 2009/10 it is beneficial for Robert to pay tax on the remittance basis, so he has to pay £20,000 tax on the amount remitted, plus the £30,000 tax charge to access the remittance basis.
- For 2010/11 Robert is better off paying tax of £80,000 on the arising basis. (The tax payable on the remittance basis would be £60,000 + £30,000.)

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Looking at the balance within Robert's offshore bank account, it is necessary to split this into taxed and untaxed funds, and this would be as follows:

	Total	Taxed	Untaxed
	£	£	£
2008/09	70,000	70,000	0
2009/10	<u>200,000</u>	<u>125,000</u>	<u>75,000</u>
	270,000	195,000	75,000
Less remitted	<u>50,000</u>	<u>50,000</u>	<u>0</u>
Balance	220,000	145,000	75,000
2010/11	<u>200,000</u>	<u>200,000</u>	<u>0</u>
	420,000	345,000	75,000
Less remitted	<u>150,000</u>	<u>150,000</u>	<u>0</u>
Balance	270,000	195,000	75,000

Where tax is paid on the arising basis, but not all of the overseas income is remitted to the UK, any balance remaining should be paid into a separate account so that it is not mixed with either the untaxed overseas income or the overseas income on which the £30,000 tax charge has been paid.

This is because the income on which tax has been paid on the arising basis may be remitted to the UK at any time without any further tax arising. Therefore in the example above, the £70,000 income arising in 2008/09 and the balance of £50,000 of the income for the year 2010/11 should be put into a separate account.

In practical terms, as the decision to pay tax on the arising basis or to elect for the remittance basis and pay the £30,000 tax charge is unlikely to be made during a particular tax year, it may be advisable to set up a new income account to receive the interest each year. This would enable the interest to be kept segregated from other interest until the decision is made.

It should be noted that the above example relates to a very simple case. In practice, tracking all cash movements is likely to require a fair degree of analysis work.

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Gains remitted before 6 April 2008

Where gains were remitted to the UK before 6 April 2008, only a proportion of the amount remitted equal to the gain element of the total proceeds is chargeable to tax. For example, if an asset cost £50,000 and was sold for £100,000, then only 50% of the proceeds is gain, so only 50% of the amount remitted would be charged to tax here. This rule has changed with effect from 6 April 2008 so that the whole of the gain is taxed before the original capital used to purchase the asset is regarded as remitted to the UK.

Payment from an overseas account

When the rules were first announced it was thought that, if paid out of overseas income or gains, the payment of the £30,000 would automatically be treated as a remittance for UK tax purposes. However, where the charge is paid directly to HM Revenue & Customs (HMRC) from an overseas bank account, either by electronic transfer or by cheque drawn on that account, the payment will not be regarded as a taxable remittance.

HMRC advises that the individual should keep sufficient records, such as a copy of the cheque, to demonstrate that the payment was sent direct from the offshore account. Where the funds have been transferred to a UK account before payment is made, this will be treated as a remittance for tax purposes even if a specific remittance is made to a UK bank account to cover this payment.

It is possible that HMRC perceives this as a way of obtaining details of the taxpayer's offshore account. The taxpayer may therefore wish to consider opening a further offshore account – possibly with a different bank – for the sole purpose of making these payments, if he does not want HMRC to have details of his other offshore account.

A further relaxation to the rules as originally proposed is to exempt minor children from paying the £30,000 tax charge until the year in which they become 18.

When not paying the charge may be better

It is not clear whether payments on account will be required in respect of the £30,000 charge where this is categorised as income tax. It is hoped that this point will be clarified in due course. However, as the first £30,000 payment due will be for the year 2008/09, and will not become payable until 31 January 2010, this is not a pressing issue at this time.

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If the non-domiciliary decides not to pay the remittance basis charge, then he will have to pay UK tax on his worldwide income and gains. For many non-domiciles this will be the less costly option, and each individual will have to review his position to see whether it will be beneficial to remain on the remittance basis. As a rule of thumb, if the offshore assets generally produce annual income of less than £80,000 it will not be worthwhile claiming the remittance basis and paying the £30,000 charge.

Where the £30,000 charge is paid, the individual will no longer be entitled to the following allowances:

- Personal Allowance, including the Married Couple's Allowance
- Blind Person's Allowance
- relief for life assurance payments
- capital gains tax annual exemption.

There is a de minimis limit where, if the overseas income and gains are less than £2,000 in any year, the remittance basis automatically applies and the above allowances are not withdrawn.

The remittance basis will continue to be claimable annually, and it will therefore be possible to switch from one basis to the other, depending which is more beneficial for a particular year. However, new anti-avoidance provisions from April 2008 bring into charge to tax any income or gains that arise in a year for which the remittance basis is claimed, even where this is brought into the UK in a year for which no such claim is made.

It should be noted that if, during a temporary period of non-residence in the UK of less than five complete tax years, an individual remits income or gains to the UK, it is likely that the amounts remitted will be liable to tax in the UK for the year of return.

Capital

Any income or gains arising prior to the non-domicile's arrival in the UK are regarded as capital, and these funds should be segregated from subsequent income or gains, so that, if required, this capital may be brought into the UK without any tax charge arising here. Where funds have been mixed, there are new rules that determine the order in which income or gains are remitted to the UK. The relevant order for each year, working backwards, is:

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- employment income not within any of the categories below
- foreign earnings that are not subject to foreign tax
- foreign specific employment income that is not subject to foreign tax
- relevant foreign income that is not subject to foreign tax
- foreign chargeable gains that are not subject to foreign tax
- foreign earnings subject to foreign tax
- foreign specific employment income that is subject to foreign tax
- relevant foreign income subject to foreign tax
- foreign chargeable gains subject to foreign tax
- any income or capital not included above, and including income or capital taxed in the UK.

It is clear from the above that keeping income and gains in separate accounts from capital and taxed income in order to avoid these identification problems is of high importance to individuals who may wish to bring funds into the UK from overseas.

Up to April 2008, where a capital gain is remitted gain will be brought within the charge to tax before any of the underlying capital may be remitted tax free.

In determining the amount of original capital it will still be necessary to track investments over a number of transactions before an amount is remitted to the UK, as it is only the original capital that remains exempt from UK tax.

The original capital may be increased after arrival in the UK, and this could arise from various sources, including:

- income or gains taxed in the UK and subsequently taken offshore
- the distribution of capital gains arising before 5 April 2008 from an offshore trust
- gifts or an inheritance from, say, a relative
- funds arising from an exempt gain, for instance the sale of the overseas home within three years of it ceasing to be used as the principal private residence.

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Keeping capital clean

Care should be taken to ensure that HMRC is unable to argue that income has been remitted here. The original capital should not be mixed with income or capital gains, but should be kept in a separate account.

Example

- Capital of £250,000 is deposited by a non-domiciled UK resident in Jersey Bank (Account No. 1).
- Interest arising is credited to a second account at the bank (Account No. 2).
- Any withdrawal from Account No. 1 may be remitted to the UK without a charge to income tax arising, as the funds in the account are capital only.
- Interest in No. 2 account may be withdrawn and spent overseas (e.g. on hotel bills while on a foreign holiday) without incurring a liability to UK income tax.

It should be noted that where overseas income is remitted here by a non-UK domicile who is assessed on the remittance basis, the remitted income does not benefit from the reduced rates of tax generally applicable to savings income, but is charged at the normal tax rates. In particular, it should be noted that dividend income is taxed at the full rates, and does not benefit from the rates of tax applied to dividends paid by UK companies or paid to UK domiciled individuals taxed on the arising basis.

Cessation of source

The Finance Bill 2008 has also introduced provisions that prevent income from being turned into capital, in particular by legislating against the practice of “ceasing the source” of the income and making the remittance in the following tax year. This is no longer effective for remittances made after 5 April 2008, and any underlying income remitted here will be taxable.

Accordingly, where a cessation of source has been carried out prior to 6 April 2007, and the capital created by the cessation of source has not been remitted to the UK by 5 April 2008, the subsequent remittance of these funds to the UK will be treated as a remittance of income as if the cessation of source procedure had not been carried out.

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It should also be noted that where a cessation of source exercise had been carried out before 6 April 2007, and the proceeds of this were remitted to the UK before 6 April 2008, then no UK tax liability arises. However, if these funds are taken back offshore, and brought back to the UK after 5 April 2008, then a tax charge will arise on the original income on which the cessation of source was carried out to the extent that it has been brought back into the UK. This is despite the fact that these funds had previously been brought into the UK as capital.

Bringing assets into the UK

A non-UK domicile has been able to buy assets such as artwork or cars outside the UK and bring them into the UK without a tax charge arising, unless the asset is subsequently sold in the UK. At that point a remittance of the original cost of the asset is triggered, even where the asset – say, a car – is sold for a fraction of what it originally cost.

From April 2008 new legislation imposes a tax charge on the cost of the asset at the time it is brought into the UK if it has been acquired using either offshore income or gains. At the time of the Pre-Budget Report it was thought that assets already in the UK would not be subject to this tax unless they were taken offshore and then brought back into the UK after 5 April 2008, when a tax charge would arise. The Budget Notes introduced some changes, so that the new rules are not so stringent.

Exemptions

The first change was the introduction of an exemption for personal effects such as clothes, shoes, jewellery and watches, and for assets costing less than £1,000. In addition, assets brought into the UK for restoration or repair, and assets in the UK for a total period of less than nine months, bought out of foreign income or gains, will not be subject to the remittance charge.

The second – and probably more important – relaxation was to exempt from the remittance charge any asset already owned by the individual on 11 March 2008 for so long as the individual continues to own that asset. It does not matter whether the asset was situated in or outside the UK on that date. Furthermore, it may be taken outside the UK and subsequently brought back into the UK without triggering a tax charge.

It should be noted, however, as mentioned above, that if the asset is sold in the UK, a tax charge will arise on the original cost. In addition, there could be a liability to CGT on any gain made on the disposal.

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A further specific exemption to the remittance charge has been introduced in respect of artwork acquired after 5 April 2008 that is brought into the UK for public display.

Capital losses

Up to 5 April 2008, capital gains on overseas assets were taxed on the remittance basis. Therefore, losses arising on the disposal of such assets could not be claimed, as it is not possible to remit a loss. This applied whether or not the remittance basis was adopted for income tax purposes for the year in which the loss arose.

From 6 April 2008, individuals may elect in and out of the remittance basis as they see fit for any particular year, and the remittance basis will include both income tax and CGT. Accordingly, in future an individual may be taxed on unremitted offshore capital gains. As a result of this, with effect from the year 2008/09 individuals are entitled to claim CGT loss relief in either of the following circumstances:

- The individual has not claimed to be taxed on the remittance basis from 2008/09.
- The remittance basis is first claimed from 2008/09.

In the latter case, the individual will be entitled to make an irrevocable election into a new regime that entitles him to CGT loss relief against gains of the same year. The losses are set firstly against remitted foreign gains, and then against unremitted foreign gains, and lastly against UK source gains.

Offshore structures

The tax treatment of offshore assets held by offshore companies and offshore trusts differ slightly from each other. It may therefore be advisable for a non-domiciled individual to review his investment structure to see whether it still fulfils its intended purpose.

There are stringent anti-avoidance provisions relating to the use of offshore trusts or companies. These are primarily directed against UK domiciled individuals. Under these provisions, a UK resident individual can be subject to a tax charge on the income of an offshore structure. However, if it can be shown that the structure was not set up with a view to avoiding tax, these provisions may not apply.

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For non-domiciled individuals, these rules have now been brought into effect from 6 April 2008. These rules will treat the non-domiciliary as if he owns the assets personally. This means that if the asset is UK situs, tax will arise; if it is not UK situs, the remittance basis may be claimed.

The provisions in relation to offshore trusts and offshore companies are discussed below.

Offshore trusts

UK source income of an offshore trust has always been liable to tax in the UK, and this continues to apply. Any income distributions to the settlor or beneficiaries will be taxable on them. But the income distributed will be net of income tax, so the recipient will be able to claim credit for the tax deducted at source.

Overseas income will be subject to the remittance basis. Thus, if the beneficiary pays the £30,000 remittance basis charge he will not be liable to any further UK tax unless he remits some of this income to the UK. If the beneficiary does not pay the £30,000 then he will be liable to UK tax on the trust income.

Prior to 5 April 2008 capital gains of an offshore trust were not taxable on a non-domiciled UK resident individual, even where the gain was remitted to the UK. From 6 April 2008, the capital gains of an offshore trust are taxed on the remittance basis whether the assets are UK situs or offshore.

Trustees of offshore trusts can make an irrevocable election to rebase all the trust assets at their value as at 6 April 2008, so that the assets will be deemed to have been acquired at their market value on 6 April 2008. Accordingly, any gains taxable on a non-domiciled beneficiary will be limited to the growth in value from 6 April 2008 up to the date of disposal.

Capital distributions made to beneficiaries will be matched to gains, but these are limited to gains made after 6 April 2008. There is thus no retrospective taxation of gains made by an offshore trust before 6 April 2008 that are distributed to beneficiaries after that date.

Under the new regime, for disposals made after 5 April 2008 the UK resident settlor will be taxed in the UK on any gain arising on UK situs assets, whether or not the gain is remitted back to the UK.

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It should be noted that the practice of using bearer warrants to change the situs of shares in a UK company was blocked by legislation introduced on 16 March 2005. This provides that a UK company will be treated as a UK situs asset for CGT purposes, so that the location of the bearer warrants is no longer relevant. So far as offshore trusts are concerned, the new legislation effectively supersedes this in any event.

Offshore companies

UK source income of an offshore company is taxable on the UK resident shareholder if he has power to enjoy the income and he is unable to show that the anti-avoidance provisions do not apply.

The overseas income of an offshore company is subject to the remittance basis. As in the case of offshore trusts, if the non-domiciled individual pays the £30,000 remittance charge he will not have to pay UK tax on the company's offshore income unless he remits some or all of the income to the UK.

The capital gains of companies do not benefit from the rebasing provisions discussed above for offshore trusts. In addition, although the remittance basis will apply in respect of offshore gains, if the overseas company makes a gain on a UK situs asset, the gain will be attributed to the shareholder and will be liable to CGT here.

Gifts

Again, the March 2008 Budget relaxed the original proposals contained in the draft Finance Bill 2008.

Up to 5 April 2008, if a non-domiciled individual gifted overseas income to another individual – for example, his spouse or his child aged over 18 – and made the gift overseas (by paying it into an offshore bank account of the donee), the donee could remit the funds to the UK without a tax liability arising, provided that the donor did not derive any benefit from the gift.

For gifts remitted to the UK by the donee after 5 April 2008, it was originally announced that new anti-avoidance provisions would seek to tax the donor as if he had made a remittance of any income or gains included within the amount of the gift the donee brought to the UK.

This has been amended so that only gifts made by the donor to his "immediate family" will be caught by these rules. The definition of "immediate family" is much narrower than the previously announced "relevant person" definition.

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“Immediate family” is defined as husbands and wives, civil partners, individuals living together as husband and wife or civil partners, and the children under 18 and grandchildren under 18 of any of those individuals.

If the donee counts as “immediate family” and remits the gift to the UK, the donor will be taxable on any income or taxable gains within the amount gifted.

Gifts of offshore income or gains made to, say, the donor’s adult son will no longer be caught by the remittance provisions. However, such gifts should continue to be made into an offshore bank account of the donee.

Buying a UK home

Before the issue of the draft Finance Bill 2008, if a non-domiciled individual wished to purchase a residence in the UK, one way of funding this was by way of an overseas bank loan secured on the UK property. This had two advantages:

- The interest could be paid to the overseas lender out of overseas income or gains without giving rise to a UK tax liability. Care had to be taken to ensure that no capital outstanding on the mortgage was repaid out of overseas income or gains, as this would be regarded as a remittance.
- In the event of the death of the individual, the loan outstanding on the property would reduce the value of his estate in the UK for inheritance tax (IHT) purposes. For this treatment to be obtained, the loan had to be secured on the UK property.

For mortgages that were already in existence on 11 March 2008, this treatment will continue for the remaining period of the loan or until 5 April 2028, whichever is the earlier. If in the intervening period the terms of the loan are varied, or further advances are made after 12 March 2008, then to the extent that the interest payments are made out of offshore income or gains they will be treated as remittances from that point forward.

UK mortgages are now regulated, and many overseas lenders are not registered with the UK authorities and are therefore unable to take a charge over the UK property. If the offshore lender has a UK presence, then one way around this is for the UK bank to take the charge over the property and to guarantee the loan to the offshore lender. Under no circumstances should the loan be made by the UK bank, as any interest paid out of offshore income would be remitted to the UK in paying the interest, and become liable to UK tax.

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Method to avoid

In the past, a popular way of purchasing a home in the UK was through an arrangement whereby an overseas company owned by an offshore trust acquired the property, and allowed the individual and his family to reside in the property. This arrangement was designed to avoid IHT without giving rise to a UK income tax charge on the individual.

Although this structure may continue to be used for the purchase of investment property, and remains tax efficient for this purpose, this method of acquiring a home in the UK should be avoided. Following a criminal court case in 1999, *Dimsey v Allen*, the individual occupying the property may be regarded as a shadow director of the overseas company. As such, he would be liable to an income tax charge in respect of benefits in kind derived from the occupation of the property.

If you occupy a property on this basis you should seek immediate advice. In particular, it should be noted that after 5 April 2008 a charge to CGT is likely to arise on the subsequent disposal of the property. Although, as discussed above, this would be taxed on the remittance basis, it is likely that the funds would be required in the UK to purchase a replacement property.

This is unlikely to be regarded as an exempt disposal of the principal private residence, as companies do not benefit from this relief. It is considered more advisable for the property to be owned directly by a trust, or even personally, although a liability to IHT may arise on death.

Inheritance tax

For IHT purposes, an individual is deemed to be domiciled in the UK if he is resident in the UK in not fewer than 17 of the 20 years of assessment ending in the year of assessment in which the relevant time falls.

For this purpose, one day in the UK can amount to a year of residence. Thus, if an individual first arrived in the UK on 5 April 1993, he may be regarded as domiciled in the UK for IHT purposes with effect from 6 April 2008. And if death occurs after this date, his entire worldwide estate will be liable to IHT.

If you are not domiciled in the UK and are approaching this milestone, you should seek urgent professional advice about possibly reorganising your affairs with a view to minimising your exposure to IHT on your overseas assets.

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At present, individuals domiciled in France, India and Pakistan are able to rely on their respective double tax treaties to avoid the deemed domicile provisions outlined above, provided that the devolution of their non-UK assets is not regulated by UK law.

The future

In December 2007 the Government issued a consultative paper in advance of the Finance Bill 2008 and has suggested that the £30,000 charge could be increased to £50,000 where the non-domiciliary has been in the UK for a longer period – say, ten years – and that the remittance basis could be withdrawn altogether for those non-domiciles who have been resident in the UK for a longer period.

The suggestion made in the consultative document was to tie this in to the time limit for IHT, so that once the non-domiciliary had been in the UK for 17 out of the past 20 years he would no longer be able to claim the remittance basis and would be liable to income tax and CGT on his worldwide income and gains.

It has yet to be seen whether these additional measures will be introduced to a regime that is already likely to have serious taxation implications for the non-domiciled community currently living in the UK. The Government has stated that, following the introduction of the above changes, no further changes will be made to this legislation for the remainder of this parliament and the whole of the next. If there is a change of government, it is unlikely that the incoming administration would be held to this.

This commentary is intended to offer some advice on the steps that should be considered, but it is only a brief guide. Before any action is taken, it is recommended that specific professional advice is sought.

Ivan Sopher & Co.

If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.