Personal tax and trust planning

AF1: 2017–18 edition

Web update 2: 14 February 2018

Please note the following update to your copy of the AF1 **2017–18** case study workbook:

Pensions advice

The plan to introduce a new income tax exemption to cover the first £500 of pensions advice provided by an employer to an employee was initially dropped from **Finance Act 2017**. It was reintroduced in **Finance (No. 2) Act 2017** and takes retrospective effect from 6 April 2017. The exemption replaces a previous, more restrictive exemption, which was limited to £150.

This change affects the following section:

- Part 1, section H1, page 28.

Dividend allowance

Finance (No. 2) Act 2017 reinstated that the dividend allowance will be reduced from £5,000 to £2,000 from the tax year 2018/19. It remains at £5,000 for 2017/18.

This change affects the following sections:

- Part 1, section B, pages 22–3.
- Part 1, section D, page 24.
- Part 1, section G2, page 27.
- Part 1, section H1, page 28.
- Part 1, section I1, pages 31–2.
- Part 1, section K1, page 35.
- Part 1, section M2, pages 38–9.
- Part 1, section Q9B, pages 50–1.
- Part 1, section T, page 60.
- Case study 1.
- Case study 2.
- Case study 11.
- Case study 13.

Property allowance

Please replace the last bullet point of Part 1, section I1 (page 31), with the following:

- There is also a £7,500 exemption where an individual lets part of their home. Property income may also benefit from the new tax allowance of £1,000, effective retrospectively from 6 April 2017. The new tax allowance gives full relief on property income of up to £1,000, with partial relief where property income exceeds the allowance by permitting an individual to calculate their property income by deducting the £1,000 allowance rather than deducting actual allowable expenses.

Deemed domicile

Finance (No. 2) Act 2017 reinstated, with retrospective effect from 6 April 2017, new rules for deemed domicile:

- A non-domiciled individual, who has been resident in the UK for at least 15 of the preceding 20 tax years, is treated as UK domiciled for the purposes of income tax, capital gains tax (CGT) and inheritance tax (IHT).
- A non-domiciled individual, who was born in the UK with a UK domicile of origin, and who is resident in the UK for the relevant tax year, is also treated as UK domiciled for income tax and CGT purposes. This will only apply, however, if the individual has been UK resident in at least one of the previous two tax years.

Various transitional provisions have also been introduced, e.g. in respect of overseas trusts and the cleansing of mixed funds.

As a result of this change, case study 10 has been revised and updated, and a new version is included within this web update (pages 3–9).

This change also affects the following sections:

- Part 1, section S, page 58.
- Case study 13.

Class 2 National Insurance contributions (NICs)

In its policy paper on the abolition of Class 2 NICs, dated 7 November 2017, the Government announced the delay of the abolition by one year. This delays the previously announced abolition from 6 April 2018 to 6 April 2019.

This change affects the following sections:

- Part 1, section F, page 26.
- Part 1, section T, page 60.

10
Coming to live in the UK

Please see overleaf for case study 10

Nathan was born in South Africa and has South African domicile. Four years ago he married Emma, a UK national who was working her way around the world. Emma was happy to settle in South Africa at first but is now feeling homesick. She also thinks, rightly or wrongly, that England is a better place than South Africa to bring up their two children, aged one and three. She has finally persuaded Nathan, who has been a dentist for the past ten years, that he could easily find work in England for more money than he is paid at home because of the shortage of dentists in the National Health Service (NHS).

Nathan has just received an offer of a position as an employed dentist in a practice in Harrogate earning £85,000 a year. They are now preparing to move. Nathan is still a bit apprehensive and has got Emma to agree to make regular visits to South Africa and not to rule out the possibility of returning there at some stage, perhaps when their children are grown up. Nathan's parents, brother and two sisters live in Johannesburg, and he is keen to see them and his nephews and nieces as much as possible.

They had been intending to sell their jointly owned house before coming to the UK but one of Nathan's sisters wants to live in the property and has offered them £80 a week rent. This is less than the market rate but Nathan's sister does not have much money, and Nathan and Emma are happy to help her. They do not have a mortgage and Nathan's sister has agreed to keep the property in good repair and pay all the bills.

As well as the property, which is worth £350,000, Nathan is retaining his portfolio of South African shares that are worth £400,000. They believe that Nathan's salary in Harrogate will be enough for both of them to live on, so he will invest the income that the shares generate. Emma wants to carry on being a full-time mother and is glad she will not have to look for a job in England.

Questions

To gain maximum marks you MUST show ALL your workings and express your answers to two decimal places.

(a) (i) Explain to Nathan how his income from the South African shares and property will be taxed in the UK. (14)

(ii) Advise Emma on what UK tax she will have to pay on her share of income from the South African property. (3)

(b) (i) Advise Nathan on the basis on which he will have to pay income tax on his employment income in the year of their arrival in the UK and in subsequent years. (4)

(ii) State what type of National Insurance contribution (NIC) liability Nathan will have on his salary and when it will arise. (3)

(c) Nathan is considering selling some of his South African shares and reinvesting in a Luxembourg-based UCITS umbrella fund. The shares he wants to sell will realise a gain of £25,000. Advise him on what his UK capital gains tax (CGT) position will be. (6)

(d) Nathan has heard that because he is South African his assets will never become liable to UK inheritance tax (IHT). He has therefore suggested that Emma transfer her share of the South African property to him using the IHT exemption for transfers between spouses.

(i) Advise Nathan on whether what he has heard is correct. (3)

(ii) Identify the UK tax implications of the transfer of Emma's share of the property to Nathan. (4)

(iii) Outline to Nathan a way in which he can permanently avoid UK IHT on his South African shares. (3)

Total marks available for this question (40)

What the case study is looking for

(a)
- A general understanding of how domicile status is determined.
- Knowledge of how residence status is determined.
- Knowledge of how overseas investment income is taxed on non-UK domiciled and UK domiciled individuals who are resident in the UK.
- An understanding of how the remittance basis works and the consequences of claiming it in a variety of circumstances.

(b)
- Knowledge of how UK employment earnings are taxed.
- Awareness of the NIC rules for individuals coming to work in the UK.

(c)
- Knowledge of the CGT rules concerning realisation of overseas gains that are not remitted to the UK.
- Awareness of the danger of remitting funds to the UK simply for banking purposes.

(d)
- Awareness of the deemed domicile rule for IHT.
- Knowledge of the spouse exemption limit where the transferee is not UK domiciled.
- Awareness of a common strategy for ensuring overseas assets remain excluded property where the owner is at risk of becoming UK domiciled or deemed domiciled.

Model answer for case study 10

(a) (i) Explain to Nathan how his income from the South African shares and property will be taxed in the UK.

- Nathan will probably retain his South African domicile for the foreseeable future. Although he and his immediate family are moving to the UK and are likely to stay for several years, he is retaining family and financial links with South Africa and has an intention to return eventually.
- He is coming to the UK to take up full-time employment on a long-term basis, and so he is expecting to stay in the UK for at least twelve months. He will therefore be treated as UK resident from the date of his arrival.
- As he is not domiciled in the UK and will have been a UK resident for less than seven tax years, he is entitled to use the remittance basis for the income arising overseas. However, he will still have a liability to UK income tax on income generated within the UK.
- If he uses the remittance basis and does not bring the income into the UK in any form, it will not be liable to UK income tax.
- If he remits income to the UK, he will be taxed on the amount of income remitted in the tax year.
- The remittance basis is automatic where unremitted overseas income and gains are less than £2,000 in a tax year. In other cases it must be claimed.
- During his first seven tax years of UK residence, if he claims the remittance basis for any tax year in which he has unremitted overseas income and gains of £2,000 or more, he will lose entitlement to his personal allowance and CGT annual exempt amount for that year.
- Therefore in 2017/18 a remittance basis claim is only beneficial if unremitted overseas income is more than £11,500.
- After seven tax years of UK residence he would have to pay a charge of £30,000 to use the remittance basis in a particular tax year if his unremitted foreign income is £2,000 or more and after 12 years of UK residence, the charge would increase to £60,000. With his present overseas income, even the £30,000 charge would be more than the potential tax saving.
- Remittance has a wide meaning. It would include buying assets abroad out of South African income and bringing them to the UK, and paying UK debts out of South African income.
- If he is within self-assessment and wishes to use the remittance basis, he must complete the supplementary non-residence pages (SA109) of the tax return stating that he is non-domiciled.
- If Nathan remains resident in the UK for more than 15 tax years out of the past 20 tax years, he will be deemed UK domiciled for income tax, CGT and IHT purposes. If Nathan had less than £2,000 of unremitted income and gains, he would still be entitled to use the remittance basis of taxation. However, if he had more than £2,000 of unremitted income and gains, no remittance basis would be available and he would be taxed on an arising basis. If Nathan subsequently left the UK after acquiring his UK domicile status, then during the first six years of non-UK residence, he would remain liable to UK tax on his worldwide assets.
- If Nathan returned to the UK in the future after having spent six tax years overseas, the 15-year clock would reset and he would be able to spend another 15 years in the UK before becoming deemed domiciled again.

(ii) Advise Emma on what UK tax she will have to pay on her share of income from the South African property.

- Emma is UK domiciled and will be UK resident on arrival. She is therefore liable to tax on her share of the rental income as it arises.
- Her share of rental income is £2,080 a year. She has no other income so this is covered by her personal allowance.

Learning points

- Nathan has a South African domicile of origin. It is not easy to divest oneself of a domicile of origin. An individual can acquire a new domicile by moving to a new country with the objective intention of permanently living there. However, a person can remain in a country for many years without becoming domiciled there because of a lack of the necessary intention. The onus of proof is basically on the person alleging the acquisition of a domicile of choice.
- Where a non-UK domiciled person lives in the UK long-term, HM Revenue & Customs (HMRC) will balance the individual's ties with their domicile of origin and those with the UK and make a judgment. However, if there are still ties (other than negligible ones) with the domicile of origin, it is unlikely that the individual has acquired a domicile of choice. Nathan's continued connections with South Africa and intention to return there suggest that it will be difficult for HMRC to show that he has acquired a domicile of choice in the UK even after many years. It should be noted, however, that once Nathan has been resident in the UK for 15 out of the previous 20 tax years, he will be deemed domiciled in the UK for both income and CGT purposes. Furthermore, his worldwide assets will be subject to UK IHT.
- Once Nathan is deemed domiciled in the UK, he will no longer have the option to be taxed on a remittance basis in respect of his overseas income and capital gains if these are £2,000 or more.
- After Nathan becomes UK resident (but is not deemed UK domiciled) he is entitled to use the remittance basis in respect of taxation of his South African investment income. If he uses the remittance basis, any income he does not bring into the UK will not be taxable in the UK.
- A person whose unremitted overseas income and gains are less than £2,000 in a tax year is taxed on the remittance basis without having to claim it and with no other consequences. A person whose unremitted overseas income and gains are £2,000 or more, which is the case for Nathan, has to claim the remittance basis on the non-residence and non-domicile supplementary pages of the tax return, in addition to claiming the non-domicile status itself. Claiming the remittance basis will result in loss of the personal allowance (£11,500 in 2017/18) and the CGT annual exempt amount (£11,300 in 2017/18), so is not advantageous where unremitted overseas income is not more than £11,500 or gains not more than £11,300. In Nathan's case it may be preferable to remit all except £1,999 of his overseas income, which would allow Nathan to escape tax on £1,999 without loss of his personal allowances.
- After Nathan has been resident in the UK for seven tax years he would have to pay a £30,000 tax charge in any tax year in which he wants to use the remittance basis. He would then need to have unremitted overseas income of more than £75,000 for a remittance basis claim to save him tax (£75,000 at 40% = £30,000).
- After Nathan has been resident in the UK for at least 12 out of the 14 preceding tax years he would have to pay a £60,000 tax charge in any tax year in which he wants to use the remittance basis.
- After Nathan has been resident in the UK for at least 15 out of the 20 preceding tax years he would be taxed on an arising basis unless unremitted gains and income amount to less than £2,000.
- Emma will be UK resident from the date of her arrival, because after her arrival her only home will be in the UK. The difference between Emma and Nathan is that she has a UK domicile of origin. It is unlikely that she acquired a domicile of choice in South Africa because she did not stay there long enough. Even if she did, individuals born in the UK with a domicile of origin (but who later acquire a domicile of choice elsewhere) are treated as domiciled in the UK as soon as they become resident in the UK.
- The property is jointly owned so her rental income is 50% of the receipts. The fact that the property is let to a connected person at less than a market rent does not alter the amount of Emma's taxable income.

(b) (i) Advise Nathan on the basis on which he will have to pay income tax on his employment income in the year of their arrival in the UK and in subsequent years.

See R03 chapters 1, 2 and 5

- It would appear that all the duties of Nathan's employment will be performed in the UK. The income will therefore be fully taxable from the outset.
- If he were to carry out any work abroad for his employer and claims the remittance basis, the income from that work would be taxable on the remittance basis in the year of his arrival and the following two tax years.

(ii) State what type of NIC liability Nathan will have on his salary and when it will arise.

- Nathan will work for a UK employer. He will have to pay primary Class 1 contributions from the outset.

Learning points

- Nathan's domicile status has no bearing on his liability to income tax on his UK employment income. Income from employment carried out in the UK is taxable in the UK, regardless of the employee's residence or domicile status.
- His domicile would make a difference if he worked for a foreign employer and carried out all the duties of that employment abroad. In that instance, he would be entitled to be taxed on the remittance basis, subject to the same conditions as outlined above, whereas a UK domiciliary would always be taxable on all the earnings as they arise. A foreign employer is one that is not resident in the UK.
- In the year of his arrival in the UK and the following two tax years, Nathan would qualify for overseas workday relief. Therefore, if Nathan claims the remittance basis, any earnings from working overseas, regardless of the residence of the employer, would be taxable only if remitted to the UK. For an explanation of overseas workday relief, go to www.gov.uk/government/publications/rdr4-overseas-workday-relief-owr.

(c) Nathan is considering selling some of his South African shares and reinvesting in a Luxembourg-based UCITS umbrella fund. The shares he wants to sell will realise a gain of £25,000. Advise him on what his UK CGT position will be.

See R03 chapter 5

- As a non-UK domiciled person, Nathan is entitled to use the remittance basis for CGT. Nathan should claim the remittance basis in the year he sells the shares, because the gain plus his overseas income will be more than the CGT annual exempt amount and personal allowance that he will lose by making a claim.
- The gain will be unremitted if the proceeds of the sale reach Luxembourg either directly or through a third country other than the UK.
- If the proceeds are routed through a UK bank and then sent to Luxembourg, Nathan will have remitted gains to the UK and therefore be potentially liable to CGT on the £13,700 gain in excess of his annual exempt amount of £11,300 (assuming no remittance basis claim is made).

Learning points

- As explained in (a), Nathan's non-domiciled status means that he is entitled to claim the remittance basis and can do so without paying the remittance basis charge if the sale takes place in the first seven years of his UK residence. If he claims the remittance basis, he will lose his CGT annual exempt amount of £11,300 and his personal allowance of £11,500. However, assuming he does not bring any of the gain into the UK, he will still be better off because the gain is more than the allowances he will lose. In addition, the claim will enable him to escape tax on all his unremitted overseas income in that tax year.
- The danger for Nathan is that he might use a UK bank to receive the proceeds of his South African sale and then post a cheque to Luxembourg. If he did this, he would have remitted gains to the UK and would therefore be liable to CGT on the £13,700 gain over his annual exempt amount, or on the whole £25,000 if he has made the remittance basis claim and not withdrawn it.

(d) Nathan has heard that because he is South African his assets will never become liable to UK IHT. He has therefore suggested that Emma transfer her share of the South African property to him using the IHT exemption for transfers between spouses.

See R03 chapter 5

(i) Advise Nathan on whether what he has heard is correct.

- This is not correct. After 15 tax years of UK residence he will be treated as deemed UK domiciled. His worldwide assets will then be within UK IHT. He may also be within IHT for South Africa and should take advice about the availability of double taxation relief.

(ii) Identify the UK tax implications of the transfer of Emma's share of the property to Nathan.

- The spouse exemption for IHT is limited to the prevailing nil rate band (currently £325,000) on a transfer by a UK domiciled individual (Emma) to a non-domiciled spouse (Nathan). This is well in excess of the value of Emma's half share of the house.
- There will be no CGT as this is a no gain, no loss transfer between spouses.
- All the rental income will be Nathan's, and he will be liable to income tax in any year in which a remittance basis claim is not beneficial. This is likely after the first seven tax years of UK residence, if not before.

(iii) Outline to Nathan a way in which he can permanently avoid UK IHT on his South African shares.

- Before he is deemed UK domiciled he could transfer his shares into a settlement. Overseas property in a settlement made by a non-UK domiciled settlor is excluded property for IHT, even if the settlor later becomes UK domiciled. It is not possible to benefit from this where UK residential property is held under the settlement.
- However, once Nathan is deemed UK domiciled, he will not be able to make any direct or indirect additions to the trust fund, or make withdrawals, otherwise the trust would lose its protected status.

Learning points

- The prevailing nil rate band (£325,000) limit to the spouse exemption where the transferee is non-domiciled should not cause difficulty in practice for a fairly young couple, because any excess will be potentially exempt and become fully exempt in seven years. Also, Emma's share of the property is only £175,000 which is well within the £325,000 limit.
- Non-UK domiciled spouses have the option to benefit from an uncapped spouse exemption by making an election to be treated as UK domiciled for IHT purposes. An election will allow a non-UK domiciled individual to receive assets from the UK domiciled spouse on death free of IHT, but simultaneously, the worldwide estate of the non-UK domiciled individual will be brought within the IHT net. If no election is made, only the UK assets of a non-UK domiciled individual are liable to IHT. The election can be backdated by seven years, but the effective date cannot be earlier than 6 April 2013.
- Nathan's non-UK domicile does not affect the CGT rules for transfers between spouses. The transfer is a no gain, no loss transfer.
- If Nathan owns the whole property, he will be taxable on all the rent. In the first seven years of his UK residence, this additional income will affect the calculation to determine whether a remittance basis claim is beneficial. From the eighth year of UK residence, it will be taxable in full because his overseas income and gains are unlikely to be high enough to make it advantageous for him to pay £30,000 to use the remittance basis. The remittance basis would be even less likely to benefit him once the £60,000 charge takes effect after 12 years of UK residency. Once Nathan has been resident in the UK for more than 15 out of the previous 20 tax years, he will be 'deemed' domiciled in the UK for income tax, CGT and IHT purposes.
- Nathan can preserve the excluded property status of his overseas investments by transferring them into a settlement before he becomes domiciled or deemed domiciled in the UK. For IHT purposes, it makes no difference whether the settlement is resident in the UK or overseas. However, Nathan will also need to consider income tax and CGT in relation to the settlor, trustees and beneficiaries, to which the residence of the settlement will make a difference. Furthermore, once Nathan is deemed UK domiciled, he will be unable to add any further funds to the trust, either directly or indirectly. If he did so, the trust would lose its protected status. He would also be unable to make withdrawals from the trust once he is deemed UK domiciled.