



US citizens resident in the UK

Major changes in the UK tax treatment of non-domiciled individuals may have significant implications for US citizens resident in the UK. Considerably more work is likely to be required in both evaluating the options and in preparing their UK and US tax returns, resulting in potentially higher tax liabilities and professional fees.

Scope

Legislation enacted in the 2008 Finance Act (FA 2008) applies to US citizens who are not domiciled in the UK and to Green Card Holders. References below to US citizens, therefore, should be taken as including Green Card Holders. The remittance basis applies to offshore investment income and gains, which are referred to below as simply income, except where the context requires otherwise. The remittance basis can also apply to offshore earnings in relatively limited circumstances.

Implementing the changes

Normally a UK resident individual is subject to UK tax on their worldwide income on the arising basis. However, a resident who is not domiciled in the UK can elect to be taxed on their non-UK source investment income on the remittance basis, so that such offshore income is only subject to UK tax as and when remitted. Generally speaking there used to be no disadvantage in claiming the remittance basis.

However, after 5 April 2008, subject to limited exceptions (e.g. for minors and individuals with minimal offshore income and gains), an individual who chooses the remittance basis will lose their personal allowance and the annual capital gains tax exemption. Typically this might increase their UK tax liability by about £5,000 p.a.

However, for longer-term residents, i.e. those who have been resident for seven or more out of the nine immediately preceding tax years, there is a charge of £30,000 p.a. (the Remittance Basis Charge or RBC) to be paid each year that they wish to be assessed on the remittance basis on their offshore income. Thus, a longer-term resident may face an increase in their UK tax liability of around £35,000 p.a. There are other

changes, including a widening of the definition of what constitutes a remittance, and new anti-avoidance legislation, which are outside the scope of this factsheet.

The £30,000 RBC is intended to be a tax on offshore income, so that the payer may be able to claim tax credit relief, if appropriate. This provision is intended to specifically benefit US citizens, who although resident in the UK, are still subject to US tax on their worldwide income. To facilitate this, anyone paying the £30,000 RBC has to nominate the specific income on which the RBC is being paid. The intention is that the foreign (US) jurisdiction should accept the £30,000 as being the tax payable on the specified or nominated income. Whilst this nomination process is intended to allow US citizens to obtain the benefit of the tax credit relief in the US, to mitigate their US tax liabilities, it is also intended that the tax payer paying the £30,000 levy should never remit the nominated income to the UK (and claim that such a remittance should bear no further tax in the UK, because of the £30,000 already paid). This is achieved, from a UK tax point of view, by some complex anti-avoidance legislation, which if triggered, could result in a wholly disproportionate UK tax liability arising. It is therefore essential that the nominated income is never remitted to the UK.

Although the UK Government has gone to great lengths to ensure that the £30,000 RBC is a creditable tax for US taxpayers, it is not certain that the US tax authorities will accept this view. On the other hand, there has also been a suggestion that the additional tax payable by a US citizen, who chooses the worldwide basis of assessment, may not be creditable in the US, as it is effectively voluntary additional UK tax. However, for the purposes of this factsheet, it is assumed that



the US authorities will allow tax credit relief in either circumstance.

Short-term residents

For US citizens who have not been resident in the UK for seven or more of the immediately preceding nine years, the situation is relatively straightforward. Such an individual can continue to claim the remittance basis, with no personal allowance or annual capital gains tax exemption. Alternatively, they can simply elect to be taxed on their worldwide income in much the same way as an ordinary domiciled individual, with the benefit of personal allowances and the capital gains exemption.

For most individuals this is a relatively simple decision. For those with very little offshore income, it is likely to be beneficial to pay UK tax on their worldwide income and gains. For those with significant unremitted offshore income, it would generally be preferable to remain on the remittance basis.

For some the choice may be less obvious. In some instances, it may be necessary to compute their tax liabilities on both bases, and compare the results. However, any such comparison needs to take into account not only the UK tax liability arising, but also the US tax effects, since the UK tax payable may well be creditable against the US tax liability. This can be quite a time consuming, and therefore expensive, exercise. In difficult cases it may well be that the simpler approach might be to remain on the remittance basis, and pay the modest amount of additional UK tax (arising because of the loss of the personal allowance etc) particularly if the additional UK tax payable could be creditable against the US tax liability, rather than undertake the detailed comparison exercise.

Longer-term residents

For the longer-term resident, who has been resident for seven or more out of the previous nine years, the problem is on a grander scale, as the payment of the £30,000 RBC is in point. However, the basic question remains: which alternative is going to give

rise to the lowest tax liability overall? There are a variety of considerations to be taken into account, as discussed below, and in some cases it may be necessary to actually calculate the overall tax position, both UK and US, to reach a decision.

Paying the £30,000 levy

For an individual paying the £30,000 levy, the additional UK tax payable, including in the effects of the loss of the personal allowances, is likely to be in the order of £35,000 p.a. in terms of UK tax payable. However, the combined effect on the UK and US tax liabilities needs to be considered, and by nominating a suitable source of income on which the £30,000 RBC is deemed to be the tax due, the overall effect in terms of both US and UK taxes may well be substantially lower. However, to achieve this result, it is necessary to nominate specific income, and this needs to be done with particular regard to the US tax implications. On the other hand, it is essential to bear in mind that the particular nominated income must never be remitted to the UK, otherwise the anti-avoidance legislation be triggered, with potentially dire effects.

Worldwide basis of assessment

The longer term resident may well take the view that, since they are being assessed in the US on the basis of their worldwide income, it may be simpler to pay tax on their worldwide income in the UK, on the assumption that essentially the UK tax payable will be allowed as a tax credit against the US tax, but this course of action will be far from straightforward. It will require careful consideration of the US/UK double tax agreement. Under the treaty arrangements, the burden of taxation will largely be shifted from the US to the UK. For example, some US source income, which previously (i.e. before 5 April 2008) had been taxed solely in the US, will in future become taxable in the UK, if the worldwide basis of assessment is adopted in the UK, and the UK tax payable would be allowed as a credit against the US tax liability, at least in principle. There may, however, be practical



limits on the amount of foreign tax credit that can actually be utilised in the US.

One of the potential problems that are going to arise is that certain vehicles and certain types of income are taxed quite differently in the US and the UK, which can lead to timing differences and the payment of UK tax which exceeds the levels for which credit relief is available in the US. For example:

i) Look through vehicles

Partnerships are generally regarded as transparent or look through for both US and UK tax purposes so that the partner is taxed on their share of the underlying partnership income, as though it were their own income, rather than on distributions or drawings. However, some companies can be similarly regarded as transparent or look through for US tax purposes, whereas companies are almost invariably regarded as opaque for UK tax purposes, so that the UK only taxes the profit from such companies when withdrawn e.g. as remuneration, interest or dividends. This mismatch can lead to timing differences, and, more importantly, because of the difference in what is actually being taxed, tax credit relief may be prohibited. This means that what is effectively the same income is, at some point, taxed in both the US and the UK, with neither jurisdiction giving credit for the foreign tax suffered in the other. It is full double taxation, with no credit relief.

ii) Mutual funds

Many US investors will invest in non-UK mutual funds or collectives. In the US, dividends or similar distributions are taxed as income, but a profit arising on the disposal is normally regarded as a gain taxable at a preferential long term gains rate (often 15%). However, in the UK, such investments are normally regarded as non-distributor or roll up funds (even though the entity may in fact distribute most of its income annually). For UK tax purposes, not only the income, but also the profits arising on disposal, are subject to income tax (potentially 40% currently). Instead of the gain arising on the disposal being subject to US tax at 15% and

UK capital gains tax at 18%, with more or less full tax credit relief available in one country or the other, the gain is taxed at 40% in the UK, thereby giving rise to a potentially significant amount of tax payable which will not be mitigated by virtue of tax credit relief.

iii) Exempt income

Certain income is specifically exempt from tax in the US, e.g. certain government securities. However, there is no corresponding exemption for such income for UK tax purposes. By opting for the worldwide basis of assessment in the UK a US citizen will therefore pay UK tax on such income, but since that income is not taxable in the US, there will be no tax credit relief available for the UK tax paid.

iv) Trusts

The tax treatment in the US and the UK of trust income, and of distributions from trusts, can vary significantly. There are also significant anti-avoidance provisions in both countries that need to be considered. This is a complex area which, in certain circumstances, can lead to the double taxation of the same income, without credit being available to any significant extent in either jurisdiction.

There are other instances where the treatment of income is inconsistent, and the longer-term resident may therefore have a difficult choice. For those with significant non-UK wealth, the simplest solution may well be to pay the £30,000 RBC, but if they do so, they will need to decide whether to try to obtain tax credit relief in the US for the £30,000 paid, by ensuring that they nominate income on which the £30,000 payment may be regarded as the UK tax payable. It is then, however, essential that they ensure that that income is never remitted to the UK, to avoid triggering the UK anti-avoidance legislation. The nominated income needs to be segregated, to guard against an unintentional remittance to the UK, and possibly even expended outside the UK.

Many US citizens may take the view that, since they are taxed on their worldwide income in the US, they might as well opt for



the worldwide basis of assessment in the UK, rather than pay the £30,000 RBC, in the belief that this may not significantly increase their overall (UK and US) tax liability, because of the availability of tax credit relief. However, this may be a mistaken belief, and a detailed review of their non-UK income may be required, in order to evaluate whether their assumptions are correct.

Either way, for many US citizens who are regarded as longer term UK residents, their UK taxation affairs are likely to be significantly more complicated. Considerably more work is likely to be required both evaluating the options and in the preparation of their UK and US returns, which will in itself lead to additional expense.

Treaty relief for dual residents

Whilst this will not apply to the majority of US citizens resident in the UK, there are a few who will find themselves in the fortunate situation of having retained a permanent home in, and strong ties with, the US, who can take advantage of the available treaty relief so that the FA 2008 changes have relatively little impact. For a US citizen, tax residence in the US, is not normally a relevant concept, since US citizens are taxable in the US on their worldwide income, irrespective of residence. It can however be highly relevant for treaty relief purposes.

For this purpose, a US citizen who retains a permanent home in the US and visits the US, is likely to be regarded as US resident. Alternatively they can be regarded as US resident if they spent a significant amount of time in the US, sufficient to satisfy the "substantial presence" test (very broadly spending about 120 days p.a. in the US).

For such individuals, who can be regarded as both resident in the UK and the US, there is a further hurdle in that treaty relief is available by reference to an individual's deemed residence for treaty relief purposes. Where an individual is regarded as actually resident in both countries, then in order to determine how treaty relief is to be applied, there is a tie breaker test, to determine in which country

they should be regarded as resident for the purposes of awarding treaty relief.

Normally a dual resident will have a permanent home in the UK, in which case, in order to obtain this beneficial treatment, they need to have retained a permanent home in the US as well. If they have a permanent home in both countries, then one has to have regard to their "centre of vital interests" which involves determining whether their personal and economic relations are closer to the US or the UK. If their centre of vital interests is determined as being in the US, then treaty relief is available to them on the basis that they should be regarded, for this purpose, as US residents.

In this situation, a US resident can be effectively exempt from UK tax on non-UK source income (and indeed in respect of certain UK source investment income). Hence they do not need to claim the benefit of the remittance basis and do not need to consider paying the £30,000 levy.

Whilst there will not be many longer-term UK residents who can benefit, there are a few, probably amongst those who have retained a permanent residence in the US, who can demonstrate that their centre of vital interests lies in the US, who can claim this treaty relief and enjoy the benefit of residing in the UK, without being subject to UK tax on the majority of their non-UK source income and without needing to consider paying the £30,000 RBC.

Spouses

It should not be forgotten that in the UK, a husband and wife are regarded as separate tax payers. It is not uncommon to find that for a married couple in the UK, one spouse has been routinely filing UK tax returns, but that the other spouse has not needed to file, because they are not domiciled here and have negligible UK source income and do not remit their offshore income to the UK. However, such spouses are similarly potentially caught by the FA 2008 changes. For 2008/09 onwards, they will need to consider whether they pay the £30,000 RBC to continue to enjoy the benefits of the



remittance basis, or whether to pay tax on the basis of their worldwide income. Even if they have not been resident in the UK for seven years, they may still need to consider their situation if they have any UK source income at all, since if they wish to continue to claim the benefit of the remittance basis, they will not be entitled to a personal allowance, and hence any UK source income can give rise to a UK tax liability, which may mean that a UK tax return needs to be filed.

Conclusion

FA 2008 brought about a major change in the UK tax treatment of non domiciled individuals and the implications for US citizens in particular, can be significant. In some instances, they have yet to be fully explored. For many there will be a significant amount of work involved in determining whether it is beneficial to adopt the worldwide basis of taxation or to pay the £30,000 RBC. Significantly greater detail may be required for non-UK source income and gains than has been the case in the past, and obtaining and evaluating such data, and considering the tax implications, is likely to involve considerably more work, and therefore cost, than in the past.

We believe the information in this document to be correct at the time it was written, July 09, but cannot accept any responsibility for any loss occasioned to any person as a result of action or refraining from action as a result of any item herein.

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