AF1: Residence & Domicile 2021/2022
Part 2: The effect on an individual's tax liability

Having established how an individual's residence and domicile is determined this part covers how this affects their liability to UK tax.

The milestones for this part are to understand:

- The difference between the arising and remittance basis of taxation.
- How an individual's residency and domicile status affects their liability to:
  - Income Tax
  - Capital Gains Tax
  - Inheritance Tax

The Arising Basis and Remittance Basis of taxation

To understand the effect of residency and domicile you must know the difference between the **Arising Basis (AB)** and **Remittance Basis (RB)** of taxation.

Arising Basis

Individuals on this basis are liable for UK tax on all their income both earnings and investment, no matter where in the world it originated together with their worldwide gains.

Remittance Basis

Individuals on RB are only liable to UK tax on income and gains arising in the UK. They do not pay tax on overseas income and gains provided it is not remitted (brought in) to the UK.

To qualify for the RB system of taxation, the applicant must be:

- Resident in the UK
- Not be domiciled or deemed domicile in the UK
- Have unremitted foreign income and gains of more than £2,000

The decision to go for RB can be taken each tax year and it's possible to be on the RB one year and AB the next. If an application isn't made, taxation will be on the arising basis.

If RB is selected following the first six years of UK residence, the individual also loses their income tax personal allowance and CGT annual exemption.

If the total of unremitted income and gains is less than £2,000, the remittance basis can be used without having to complete a self-assessment form and the individual will retain their personal allowance.

There is a further exception for anyone who has a small amount of foreign income from employment.

The individual must be:

- UK resident
- Not domiciled in the UK
- Employed in the UK
- A basic rate taxpayer based on worldwide income
- Have overseas income from employment is less than £10,000, overseas bank interest of less than £10 and all overseas income is subject to foreign tax
- Have no other overseas income or gains
- Does not have to complete a self-assessment form

If all the conditions are met, they won't be liable to UK tax on the foreign income and don't need to claim the remittance basis,

More about the remittance basis

The person who applies for RB is termed "a relevant person" In addition

- their spouse/civil partner with whom they live
- their children and grandchildren under 18

would also be considered relevant persons. This is to prevent someone who elected for RB passing income through their spouse or children.

Individuals who have elected for RB can bring **clean capital** into the UK without a tax charge. This will include:

- Income and gains before becoming UK resident
- Income and gains that were taxed on an arising basis.
- Outright gifts and inheritances from other individuals.

In practice a non-domiciled person's overseas assets will be a mixture of clean assets and other assets that would be subject to UK tax if remitted. HMRC will require the untaxed funds to be remitted first which can make it difficult to use the clean capital without first triggering a tax charge.

One potential loophole that might be used when remittance basis is chosen is to bring assets bought outside the UK and then convert them into cash. Such transfers would be considered as income or gains. There are though some exceptions that can be brought into the UK without a tax charge.

These are:

- Personal effects
- Assets brought to the UK for repair
- Assets brought into the UK for a total period of less than 275 days
- Works of art brought into the UK for public display
- Certain assets bought before 12 March 2008

How all this affects different individuals will now be considered.

The effect on income tax liability

There are a three basic principles.

- Regardless of their status all individuals are liable to pay income tax on UK income.
- **non-residents** have no UK liability on income arising from outside the UK.
- The way in which **residents' non-UK income** is taxed depends on their domicile status.

To illustrate this:

Alan who is **resident and domicile** pays income tax on his salary and on the interest on a deposit account in Jersey.

Agnieska is **resident but non-domicile**. She is employed in the UK tax and rents out her flat in Warsaw. She pays tax on her UK salary but does not need to pay UK tax on her Polish income.

Chris works in New York and is **non-resident but UK domicile**. He does not pay UK tax on his American salary. He kept his UK home which he rents out. He is liable for UK tax on this rental income.

Susanne is an American academic and is **non-resident and non-domicile**. She come to Britain to give a series of lectures. She is liable to UK income tax on the fee she is paid.

Resident and UK Domicile (including Deemed Domicile)

Jenny opens a deposit account in Jersey. Even though she accumulates the interest in the account she will still be liable to pay tax on the interest

Jules is UK resident but has become deemed domicile. He has substantial investments in France. The income from these must be declared and is liable to be taxed in the UK

In Jules case this means his French income could be taxed both in France and the UK which is inequitable. To counter this the UK has **Double Taxation Agreements (DTA)** with most countries. These are complex but the general principles were tested in the April 2017 exam.

- The individual's country of tax residence tends to have the right to tax earnings from employment.
- The DTA aims to avoid individuals being taxed twice.
- Tax paid in one country can usually be offset as a credit against tax paid in the second one

If a UK resident receives a non-UK pension, this is usually reduced by 10% before it is taxed. All non-UK income is converted into GBP at the HMRC rate on the date it is paid.

Resident and non-domiciled

As explained previously resident non-domicile individuals can elect to be taxed on the **Remittance Basis (RB)** Prior to the changes in the Finance Act (number 2) 2017 this situation could continue indefinitely but it is now time limited.

A non-domicile, provided they aren't an FDR can elect to be taxed on the remittance basis free of charge for the **first six years of residence**.

Gustav moved to the UK to work full time in 2015/16 and became UK resident. He must pay tax on his UK income. In addition he has considerable investments in Germany but elects to be taxed on the remittance basis. Provided he doesn't remit this income to the UK it will not be subject to UK tax.

In his **seventh year** of being resident he will still be non-domicile but will be switched to the arising basis becoming potentially liable to tax on his overseas income. However, he can remain on the RB basis if he pays the **Remittance Basis Charge. (RBC)** This is **£30,000** and is also payable in his **eighth, ninth, tenth and eleventh year** of residence. It will also result in the loss of the personal allowance and capital gains tax allowance.

In the **twelfth, thirteenth and fourteenth year of residence** the RBC is increased to **£60,000**

The RBC is voluntary and can be changed from one tax year to the next. If someone chooses not to pay it, they will be taxed on the arising basis.

In the **fifteenth of residence year** Gustav would be **deemed domicile** and will be taxed on the arising basis.

All the previous examples are based on Gustav being continuously resident. He would be subject to the RBC and be deemed domicile on the following basis:

Years of resident	
Less than six years	Non-Domicile. Can keep remittance basis with no charge
Seven out of the last nine	Non- Domicile. To keep on the remittance basis an RBC of £30,000 is payable
Twelve out of fourteen	Non-Domicile. To keep on the remittance bonus an RBC of £60,000 is payable
Fifteen out of twenty	Deemed domicile No option other than Arising Basis

Whether it is worth paying the RBC will depend on whether the charge and additional tax through loss of PA is more or less than the tax that would be paid on non UK income if they went on to the arising basis.

Having paid the RBC, you can offset this against tax due on any income remitted to the UK.

The effect on CGT liability

For residents the situation is broadly similar to income tax.

- Individuals who are **UK resident and UK domicile (including deemed domicile)** will be taxed on the arising basis and are liable to CGT on disposals arising anywhere in the world.
- Individuals who are **UK resident but non-UK domicile** can elect to be taxed on the RB so only pay CGT on UK gains and overseas gains remitted to UK.
- **Non-residents** will not normally be subject to CGT on UK gains with the exception of UK residential property.

As with income tax, after six years residence a non-domicile will be switched to the arising basis and liable to CGT on worldwide assets unless they pay the relevant Remittance Basis Charge. If they are resident for fifteen out of the last twenty years they will be deemed domicile and liable to CGT on worldwide gains. An FDR is deemed domicile in the year they become UK resident and cannot use the remittance basis.

Rebasing of offshore assets

As a concession, individuals who became deemed domicile on April 6 2017 (but not later) and who are not a FDR, can rebase the acquisition cost of their assets to their value at April 6 2017.

To qualify for this rebasing the owner must:

- Have been a UK resident on 6 April 2017.
- Have paid the RBC in any year before 5 April 2017
- Be deemed domicile from 6 April 2017 to disposal of the asset.

In addition the asset must not have been brought into the UK at any time between 16 March 2016 and 5 April 2017

A decision to rebase can be taken on an asset by asset basis. This can be useful if the value on 6 April 2017 is lower than the acquisition value.

Non UK-residents

Non-residents now have a liability on the disposal of UK residential property sold or disposed after 6 April 2015.

The base cost for calculating the gain will be the value at 6 April 2015 or acquisition value if purchased after that date. The gain will be calculated in the normal way and the rates will be 18% and 28%. The annual exemption will also be available.

The general exemption for non-residents is also tempered by specific anti-avoidance legislation to prevent individuals avoiding UK CGT by becoming non-resident for a short period and realising gains whilst non-resident.

This will apply if:

- The assets sold were owned when the individual became non-resident.
- They were UK resident for 4 of the last 7 tax years
- The period of non-residence is five years or less

This is termed **temporary non-residence**. The five years is five calendar years plus 1 day, for example May 4 2015 to May 4 2020.

If they return to the UK within the five years the gain will be taxable in the year of return without the benefit of the annual exemption.

Sandra is UK resident and domicile and leaves to work in Spain.

Three years later she sells some UK assets. At this point she doesn't have to pay CGT but if she returns to the UK in the following year (four years after leaving) then she will be taxed in that year at the normal rate and with no annual exemption.

The effect on IHT liability

The general rule is that:

- Individuals with UK domicile are liable for IHT on assets held anywhere in the world.
- Individuals with non-UK domicile are only liable on their UK assets.

The 15/20 rule applies to IHT so once an individual becomes deemed domicile they will be liable to IHT on worldwide assets. There is one slight difference for IHT. If an individual becomes deemed domicile they can lose this **for IHT only** by becoming non-resident for four tax years.

Veronique became deemed domicile in 2014/15. If she becomes non-resident in 2018/19 from 2022/23 she will only be liable for IHT on UK assets. If she becomes resident in 2023/24 she will again be liable to IHT on worldwide assets.

She would then have to be non-resident for six tax years to reset the clock and start a new 15/20 period.

An FDR becomes deemed domicile in the tax year they become resident but this rule is eased slightly for IHT. They will be allowed to return for a limited period without affecting their domicile for IHT purposes. This is up to the end of the first tax year in which residence is re-established provided they have been non-resident for the two previous years.

Isaac is an FDR who now lives in Israel and is non-domicile. On July 1 2018 he returns to the UK as his father had become seriously ill. He remains until May 1 2019 when he returns to Israel. He would not be deemed domicile for IHT in 2018/19, under the “period of grace” and 2019/20 as he would be non-resident under the Statutory Residence Test.

If Issac was resident in the UK for more than 183 days in 2019/20 he would deemed domicile and subject to IHT on worldwide assets. If he leaves in early 2020 he will lose his deemed domicile in 2020/21, that is the year after he loses his residential status.

Lifetime transfers to a non-domiciled spouse/CP

Lifetime transfers to a non domiciled spouse are only exempt on the first £325,000. The logic of this is that as the overseas assets of a non-domiciled spouse a UK domiciled individual could transfer property to their non-domicile spouse who would then transfer it overseas. It would then escape IHT completely.

There are two key points about this £325,000 limit.

- It applies to both lifetime gifts and transfers on death.
- It is a lifetime allowance.

Jack is UK domicile and gifts £400K to his non domiciled spouse, Veronique.

Assuming no previous gifts were made, £6,000 will be exempt under annual exemption and £325,000 under non-domiciled spouse's exemption. This gives a total of £331,000 and the balance of £59,000 is a PET

If Jack dies 10 years later and leaves everything to Veronique, there is no spousal exemption and everything above the Nil Rate Band will be chargeable at 40%

That now concludes this part so you should now understand:

- The difference between the arising and remittance basis of taxation.
- How an individual's residency and domicile status affects their liability to:
  - Income Tax
  - Capital Gains Tax
  - Inheritance Tax

Further Reading

https://www.gov.uk/tax-foreign-income/residence

https://www.litrg.org.uk/tax-guides/savers-property-owners-and-other-tax-issues/capital-gains-tax/capital-gains-tax

https://www.morton-fraser.com/knowledge-hub/uk-inheritance-tax-the-domicile-trap