SULLIVAN & CROMWELL LLP

14 August 2012

UK Tax Residence

Proposed Statutory Definition of Tax Residence for Individuals

SUMMARY

The UK government has released draft legislation for a statutory residence test ("SRT") for individuals. The new test is intended to give the same outcome as the existing test in most cases. The aim is that it will be more transparent, objective and simple to use.

Key features of the SRT include:

- simple rules to deal with the more straightforward cases;
- separate treatment of "arrivers" and "leavers";
- the placing of "split-year" concessions on a statutory footing; and
- a reduction in the number of factors which may affect residence.

The SRT would apply to individuals for the purposes of:

- income tax;
- capital gains tax; and
- inheritance tax.

It would not apply for the purpose of National Insurance (social security) contributions.

The government proposes that the new definition would apply from 6 April 2013 (the start of the next UK income tax year).

The SRT would bring a welcome degree of clarity to what has been an unsatisfactory area of law.

BACKGROUND

The task of defining what it is for an individual to be "resident" in the UK has fallen, by default, to the courts. Judges have identified several factors as relevant:

- whether an individual has accommodation available to him in the UK;
- the length, purpose and frequency of his visits to the UK; and
- the extent of his ties to the UK.

The result is a test which is highly fact-sensitive and difficult to apply in practice. Parliament has grafted on some limited statutory rules. In practice, however, HM Revenue & Customs has played a significant role, both by adopting extra-statutory concessions and by publishing guidance. The existing rules, however, are unacceptably vague, especially for internationally mobile individuals – as witness the cases, decided in October last year, of *Gaines-Cooper* and *Davies and James*.[1] The government proposes to resolve the uncertainty – at last – by putting the residence test on a statutory footing and by making it transparent, objective and simple to use. HM Treasury and HMRC issued a joint consultation document setting out their proposal for a new statutory test on 17 June 2011.[2] That consultation closed on 9 September 2011. Following the consultation, the government decided to extend the timetable for consulting on and enacting the new test. On 21 June this year the government issued a further consultation document, along with draft legislation.

The intention is that the new test will be included in the Finance Bill 2013 and apply from 6 April 2013.

The government identified three principles underlying the proposed framework of the new test.

1. Application to both straightforward and complicated cases. The SRT is intended to make it easier for all individuals to self-assess their tax residence status, regardless of how simple or complex their affairs may be.

2. Relevance of both time spent in the UK and personal connections. The government recognises that the concept of residence should continue to involve more than simply counting the number of days one spends in the UK in a given tax year. The strength of a person's connections with the UK will also be taken into account, but in the interests of simplicity and clarity, the number of factors which may be considered will be limited, and their weighting made clear.

3. Adhesive ("sticky") nature of residence. The government takes the view that someone who is already resident in the UK in one tax year should be more likely to be resident in the UK in subsequent

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1 See our client memorandum of 31 October 2011, available at www.sullcrom.com/uk-tax-residence-10-31-2011.

2 See our client memorandum of 25 July 2011, available at www.sullcrom.com/uk-tax-residence-07-25-2011.

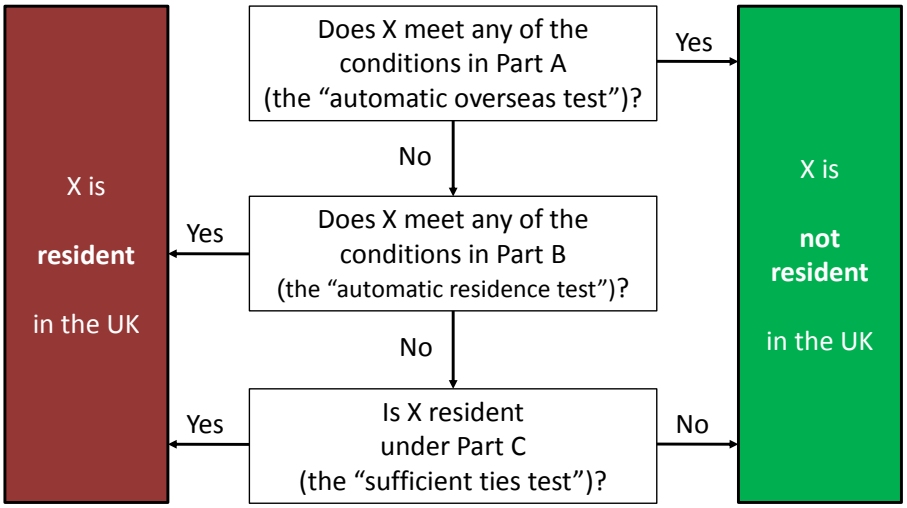
years (and claims that this principle derives from case law). This stance is likely to increase the number of cases of dual residence among internationally mobile individuals. Accordingly, the proposed SRT treats "arrivers" and "leavers" differently (see below).

THE PROPOSED TEST

Overview

Scope. The SRT would apply to individuals for the purposes of income tax, capital gains tax and inheritance tax. It will not apply to companies or – unhelpfully – for the purposes of National Insurance contributions. (The government argues that, because NICs are usually assessed on a pay period basis, rather than annually, it would be impractical to apply the statutory residence test in this form to NICs.)

Structure. The proposed SRT involves up to three stages:



Each of Part A and Part B consists of a list of conditions, only one of which needs to be met. Part C is more complex. It involves testing the number of connection factors ("UK ties") an individual has against the number of days he or she has spent in the UK.

Stickiness. Part A and Part C apply different rules to "arrivers" (those individuals who *were not* UK resident in *all* of the previous three tax years) and "leavers" (anyone who *was* UK resident in *any* of the previous three tax years). The effect of drawing the distinction in this way is to make it more difficult to become non-resident when leaving the UK after a fairly limited period of residence than it is to become resident when an individual comes to the UK.

Part A: conclusive non-residence – the "automatic overseas test"

Under Part A, arrivers will be non-UK-resident if they have been present in the UK for fewer than 46 days in the current tax year. Leavers, however, will only be treated as non-resident if they are present in the UK for fewer than 16 days. The SRT also provides that those who leave the UK to carry out full-time work abroad ("FTWA") will be treated as non-resident, provided they are present in the UK for no more than 90 days in the tax year and no more than 20 days are spent working in the UK in the tax year.[3] The government has invited comments on increasing the number of working days allowed in the UK from 20 to 25 working days. The relevant qualifying period for FTWA is at least one complete tax year.[4]

Under the proposed SRT, the meaning of "day of presence in the UK" will remain a question of counting the number of midnights a person is present in the UK (ignoring some transiting airline passengers). By contrast, a "working day" will be defined under the SRT as any day on which an individual carries out more than three hours of work, regardless of whether or not he or she is present in the UK at the end of the day.[5] The government has raised the possibility of increasing the number of hours that constitute a working day from three to five hours. (The government is not offering to raise the length of a working day in the UK as well as the number of working days allowed in the UK: it would be one or the other.)

Part B: conclusive residence – the "automatic residence test"

If Part A of the test does not apply, individuals will be resident for the tax year under Part B if they meet any of the following conditions:

- (as under the existing law) they are present in the UK for 183 days or more in a tax year; or
- they have only one home and that home is in the UK (or have two or more homes and all of them are in the UK); or
- they carry out full-time work in the UK ("FTWUK").

The consultation document specifies that residential accommodation will not be treated as an individual's home if that accommodation is being advertised for sale or let and the individual lives in another residence. "Home" itself, however, is not defined: the government has concluded that "home" is extremely difficult to define precisely, but the vast majority of people will know what their home is.

The government has asked for feedback on whether to increase the qualifying period for FTWUK from nine months to twelve months.

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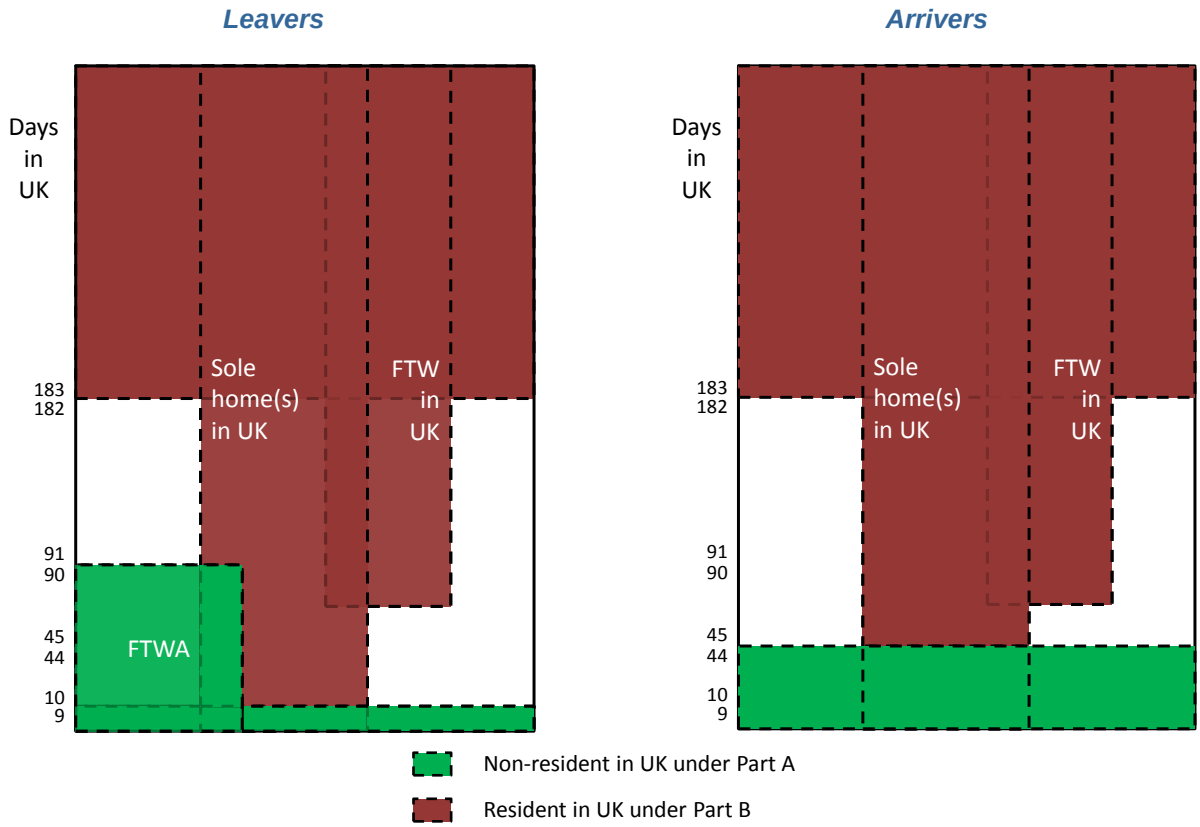
[3] The consultation document suggests that, as under existing practice, the FTWA condition for non-residence applies only to leavers, not to arrivers. This is surprising, since – in theory at least – it could also benefit arrivers. (An arriver in the same circumstances would be non-resident under Part C, but only so long as he or she was not resident under Part B.)

[4] It is proposed that international transportation workers will be excluded from being eligible for FTWA.

[5] Again, there will be a different rule for international transportation workers.

The position for leavers and arrivers under Part A and Part B is summarised in the diagrams below.



Part C: other connection factors and day counting – the "sufficient ties test"

Part C applies where an individual's status is not settled by Part A or Part B. It departs from the case law test by providing an exhaustive list of UK ties that are relevant to a determination of residence, which an individual will need to compare against the number of days he or she spends in the UK. Another departure lies in the proposal that they should be equally weighted (rather than the weighting being a matter of impression for the courts). Essentially, the more time individuals spend in the UK, the fewer UK ties they must have if they are to escape being classified as resident. As in Part A, the rules to be applied vary according to whether an individual is an arriver or a leaver. In Part C, however, leavers are also effectively divided into two classes: they are treated differently according to whether they have spent more days in the UK than any other country.[6]

The following UK ties are relevant to the UK residence status of arrivers and leavers.

- A ***"family tie"***. "Family" is defined under the proposed SRT as consisting of:
  - a spouse, civil partner or common law equivalent, except a spouse from whom the individual is separated (where the separation is by order or agreement or likely to be permanent); or

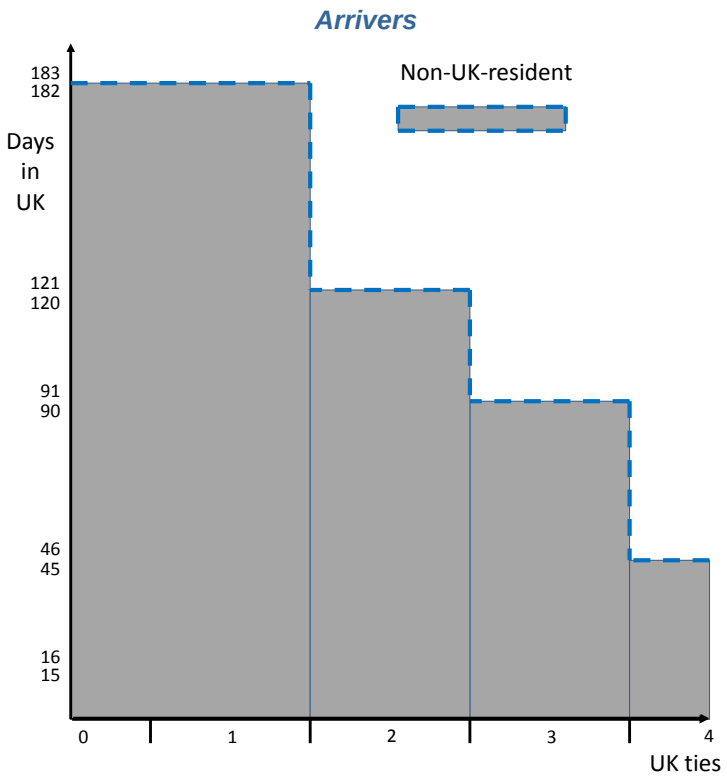
[6] This is framed in the consultation document and draft legislation as an additional UK tie which may be relevant to leavers.

  - children under 18 years of age with whom the individual spends all or part of 61 days or more in the UK in the tax year; there is an exception for children who are resident in the UK because they are in full-time education in the UK but spend fewer than 21 days in the UK outside term time. (The details of this exception have changed from the version suggested last summer.)

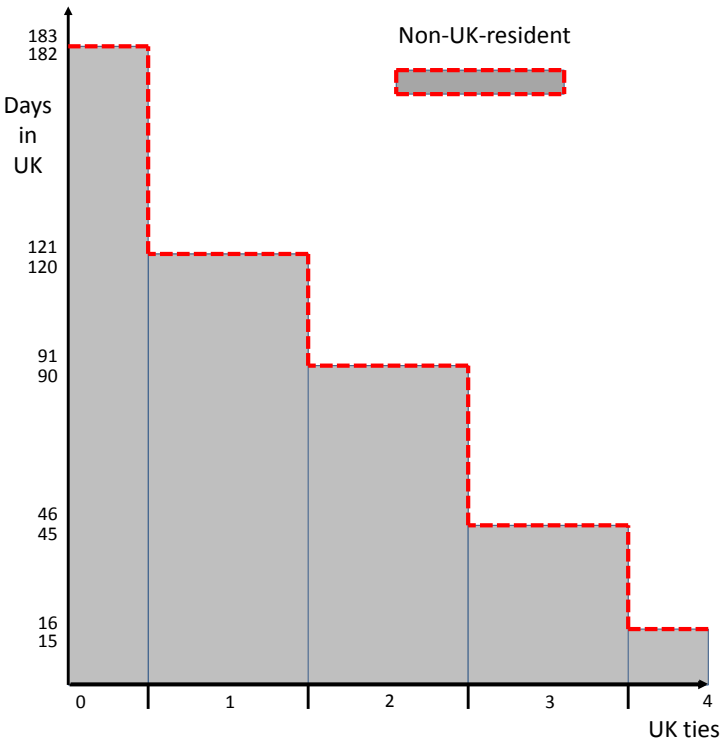
- A ***"work tie"*** (which includes self-employment). An individual who works in the UK for 40 days or more will have a work tie. Three hours of work in a day is enough to qualify (although this may be increased to five hours), and it does not matter whether the individual has left the UK by the end of the day.
- An ***"accommodation tie"***. This will apply if:
  - the individual has a place to live in the UK;
  - it is available to be used by him or her for a continuous period of 91 days in the tax year (subject to an anti-avoidance rule);
  - the individual spends at least one night there during the year. (Accommodation held by "close relatives" will count only if the individual spends more than 15 nights there during the year.)

  All accommodation that satisfies these criteria will count: what right the individual has to use the accommodation is irrelevant.
- A ***"90 day tie"***. The individual has spent more than 90 days in the UK in either of the previous two tax years.

Each individual must determine how many of the four common UK ties are present in his or her case and then set them against the number of days he or she spends in the UK.



Leavers not spending more days in the U.K. than any other jurisdiction



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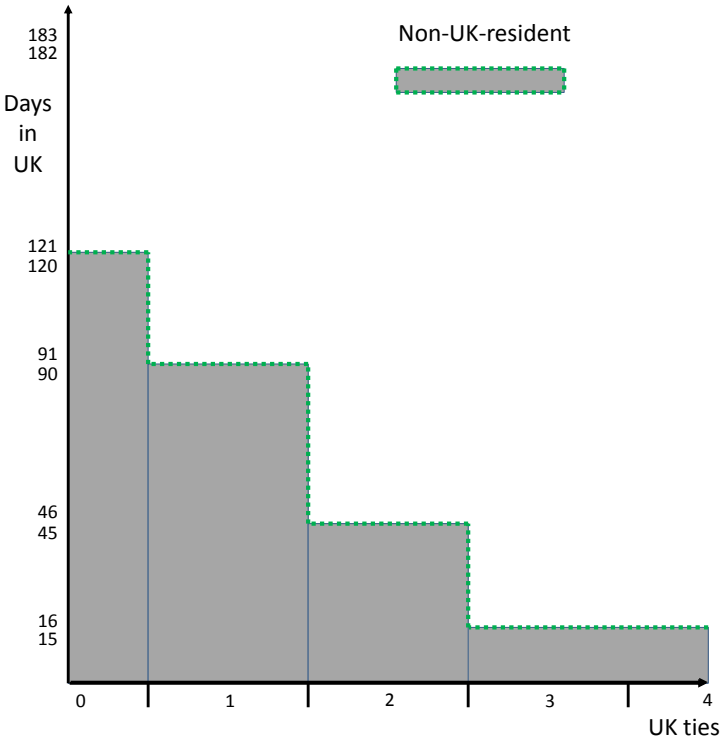

OTHER POINTS

Transitional rules. Under the SRT, a person will be classified as either an "arriver" or "leaver" depending on whether or not he or she was resident in the UK in any one of three previous tax years. This raises the question of whether individuals should apply the old or the new definition of residence for years up to 5 April 2013 to work out whether they are arrivers or leavers. The government has decided that individuals should be able to elect to apply the new rules to previous tax years in order to determine their residence status under the new SRT. The new rules may not be applied to previous tax years for any other purpose.

Exceptional circumstances. Where an individual spends time in the UK for reasons beyond his or her control (such as hospitalisation), those days of presence will be disregarded for the purposes of day-counting. This exception will be limited to 60 days per year.

Split-year treatment. By concession, HMRC allows an individual to split a tax year into periods of residence and non-residence where an individual comes to or leaves the UK part of the way through the tax year. The government intends to put this concession onto a statutory footing, amending the conditions which the taxpayer must meet to fit with the new SRT.

Anti-avoidance rules. The government is concerned that offering taxpayers certainty as to whether they are resident or not could allow them to plan their affairs to avoid income tax. The consultation document proposes an anti-avoidance rule, taxing temporary non-residents on some types of investment income whose quantum can be raised fairly easily (such as dividends from privately-owned companies meeting particular criteria). The income would be treated as arising on their return. How this interacts with the UK's double tax treaties and whether credit is available for tax suffered while overseas will need to be worked through. (A similar rule was brought in for capital gains tax in 1998.)

Ordinary residence. The slightly separate concept of "ordinary residence" is to be abolished for most purposes. Currently, an individual who is resident, but not ordinarily resident, in the UK is entitled to be taxed on foreign investment income and UK-source employment income for duties performed outside the UK only when he or she remits the income to the UK (for UK-source employment income, this is known as "overseas workday relief"). An individual who is ordinarily resident, but not resident, in the UK remains subject to capital gains tax. The government proposes to retain overseas workday relief, replacing the requirement that the taxpayer is not ordinarily resident in the UK with a broadly similar statutory test *and* restricting the relief to non-UK-domiciled individuals. The remittance basis for investment income would apply only to UK-resident but non-UK-domiciled individuals.

PRACTICAL IMPLICATIONS

The SRT would significantly clarify the current rules relating to tax residence. There is scope for improvement, however, and any would-be non-resident would still need to bear other legal and practical considerations in mind. We note two of them below.

Double Taxation Agreements. The SRT would define the UK domestic law position. Individuals who would be "resident" under the SRT may still be able to claim the benefit of a double taxation agreement if they are resident elsewhere. Individuals will need to ensure they are well-informed about the relevant treaty "tie-breaker" rules relating to their situation in order to minimise their liabilities in both the UK and abroad. The UK's stated policy of making it harder for "leavers" to escape UK residence may make these tie-breaker rules more significant.

Documentation. Taxpayers should continue to retain accurate records of their international movements as far as possible. Anyone treated as a "leaver" will need to be able to show not just whether they were in the UK or elsewhere on a given date, but where they were outside the UK, if they intend to claim that the UK was not the country where they spent the most time.

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