FORSTERS
PRIVATE CLIENT

Countdown to 6 April 2017 for non-UK domiciliaries

December 2016

In July 2015, the Government announced significant changes to the taxation of resident non-UK domiciled individuals and their property holding structures, taking effect from 6 April 2017. Nearly two years after the changes were announced, a response to the consultation and draft legislation released this week reveals a new regime that in several important respects is less far-reaching than originally proposed. However, certain key elements of the proposed legislation are still in progress and may not be published until shortly before the changes take effect.

In this briefing, we highlight the key aspects of the proposals as they currently stand, and suggest some of the steps that individuals and trustees affected by the changes may wish to consider taking before 6 April 2017.

Deemed domicile for long term residents

Existing rules

Currently, the concept of "deemed domicile" applies for inheritance tax purposes only, and (other than in cases where complex split-year rules apply) is generally triggered at the start of the 17th consecutive year of residence. At that point, non-UK domiciliaries, who until then are subject to inheritance tax on UK assets only, become subject to inheritance tax on a worldwide basis.

New rules

From 6 April 2017, deemed domiciled status will apply for all tax purposes once an individual has been resident in 15 of the previous 20 tax years, which (absent split year treatment) will mean the start of the 16th consecutive tax year. This brings forward by a year the point at which long-term residents become subject to inheritance tax on their worldwide personal assets. The changes will apply immediately to all non-

domiciliaries who meet the 15/20 year rule on 6 April 2017. Those who are affected should consider taking steps to preserve inheritance tax protection by settling suitable assets into trust before then.

More significantly, the extension of the deeming provision to income and capital gains will mean that those who are deemed domiciled under the new 15/20 year rule will no longer be eligible for the remittance basis. Appropriate strategies may include settling assets into trust before 6 April 2017 in order to benefit from a new "protected settlements" regime, and to make use of the transitional provisions for rebasing assets and separating mixed funds. These provisions are dealt with below.

For those wishing to "restart the clock" by becoming non-resident for a temporary period before returning to the UK, six complete tax years of non-UK residence will be needed to break the deeming provision. The same will apply to those who left before 6 April 2017, if they resume UK residence after that date. For those who are not returning, deemed domicile status will be lost for inheritance tax purposes only after three complete tax years of non-UK residence (i.e. from the beginning of the fourth non-resident year). This aligns with the current position, and is a concession in response to the consultation (previously, it was proposed that four complete tax years would be needed).

There are some potential traps for the unwary. For instance, as the new 15/20 year rule looks to the 20 prior tax years, an individual can become deemed domiciled in a tax year of non-UK residence. This will be the case where the individual is UK resident for 15 consecutive tax years and becomes non-resident in the 16th year. To avoid this, it will generally be necessary for non-domiciliaries to leave the UK before the end of their 14th year of residence, although there is an exception for individuals who become non-UK resident in 2017/18 and who would otherwise become deemed domiciled in that year.

Returning non-domiciliaries

As announced by the Government in July 2015, individuals born in the UK with a UK domicile of origin, but who have subsequently acquired a domicile of choice outside the UK, will no longer be able to benefit from their non-domiciled status after 6 April 2017 while they are UK resident. Instead, they will be treated as UK domiciled for all purposes on their return to the UK (albeit with a short grace period before their worldwide assets become subject to inheritance tax). This means that they will not be able to claim the remittance basis. They will also not be able to benefit from the transitional rules for mixed funds, rebasing provisions, or the new protected settlements regime, as discussed below.

Mixed Funds

Non-domiciled, UK resident individuals holding accounts outside the UK which contain a mixture of income, capital, and capital gains, cannot currently use these funds in the UK without a charge to tax: the legislation provides an order of priority in which funds are deemed to be withdrawn from the account. These rules work against the taxpayer in that (taxable) income and gains are deemed to be withdrawn before (tax-free) capital.

The August 2016 consultation outlined proposals for a one year window of opportunity in which individuals who have been taxed on the remittance basis would be able to segregate their mixed funds held in overseas bank accounts, allowing them to override the mixed fund rules and bring the capital element of their accounts into the UK free of tax. In the response to the consultation, the Government has announced that it will extend this window to two years, running from 6 April 2017 to 5 April 2019. As previously announced, the favourable treatment will be available where it is possible to quantify a minimum capital component of the mixed fund.

In addition to identifying whether they have existing mixed accounts, eligible individuals may wish to consider the sale of assets that will give rise to mixed funds within the two-year window.

Rebasing
The August 2016 consultation proposed that individuals who will become deemed domiciled on 6 April 2017 under the new 15/20 year rule will be able to rebase their directly-held foreign assets to their market value on 5 April 2017 for capital gains tax purposes. Whilst this may appear generous, various conditions are attached which will limit the availability of the relief.

Rebasing will only be available to individuals who:
- become deemed domiciled on 6 April 2017 (and no later);
- have paid the remittance basis charge in an earlier tax year; and
- were not born in the UK with a UK domicile of origin.

Furthermore, rebasing will only be available in respect of assets which:
- are owned directly by the individual on 5 April 2017; and
- have not been situated in the UK at any time between 16 March 2016 (or the date of acquisition, if later) and 5 April 2017.

In light of this, individuals with assets which would benefit from rebasing should consider delaying anticipated sales until after 5 April 2017. Those who have not paid the remittance basis charge to date should also consider whether it would be worthwhile to pay it in respect of this (or an earlier) tax year in order to give themselves the opportunity to rebase.

Protection for non-UK trusts
The proposals regarding the tax treatment of income and gains arising within non-UK resident trusts have been softened in response to concerns raised during the consultation in relation to some of the harsher elements of the new rules.

However, while the draft capital gains tax legislation is now available, disappointingly the Government has not published any draft legislation for the income tax provisions. It may be that this will not be available until next March. Nevertheless, the response to the consultation provides a strong indication of what is to come.

Capital gains
Currently, capital gains arising in a non-UK trust are not subject to tax in the hands of the trustees, but may be attributed to a settlor who is both UK resident and domiciled. From 6 April 2017, subject to the "protected settlement" rules described below, this automatic attribution of trust gains will be extended to UK resident settlors who are deemed domiciled under the new rules.

Protected settlements
Trusts settled by a non-domiciled individual will be exempt from the automatic attribution of gains provided that the settlor (or the trustees of any other trust of which he or she is a settlor or a beneficiary) either remains non-UK domiciled, or (if he or she becomes deemed domiciled under the new rules) does not add property or income to the trust once he or she becomes deemed domiciled. For these purposes, property or income added under a transaction at arm's length or under a liability incurred by any person before 6 April

2017 is ignored. Additions to cover a shortfall needed to pay administrative costs and tax liabilities are also permitted.

Where a trust has protected status, "capital payments" (which means capital distributions and certain other benefits) made to beneficiaries may be subject to tax with reference to capital gains that have been realised within the trust. This mechanism (known as "matching") is the same as under the existing regime, but with some important modifications.

Close family members
If a capital payment is made to a "close family member" (meaning a spouse, cohabitee partner or minor child, but not minor grandchildren) of a UK resident settlor, the capital payment will be matched against trust gains, as under the existing rules. However, if the recipient beneficiary does not pay tax on the gain attributed to him or her (either because the recipient is non-resident, or claims the remittance basis of taxation and does not remit the capital payment before the end of the tax year) the settlor will be liable for the tax instead if UK resident.

Non-UK residents
Currently, a capital payment to a non-resident beneficiary is matched with trust gains, but the recipient is not subject to tax. This reduces the gains which are available to be matched with distributions to UK residents. The draft legislation aims to prevent this, by ignoring capital payments made to non-residents (other than close family members) for the purposes of the matching rules. There is an exception where capital payments are made to a combination of UK resident and non-resident beneficiaries on the termination of a trust.

Where trustees of trusts with significant unmatched gains intend to make distributions to non-UK residents in the foreseeable future, they may wish to consider bringing these forward to before the new rules take effect.

Onward gifts
The Government is also concerned about the opportunities afforded by "onward gifts". The draft legislation contains provisions preventing non-resident or non-domiciled beneficiaries from receiving a (tax-free) capital payment, and subsequently passing on the distribution to a UK resident individual (who would have been taxable had he or she received the distribution directly). Where the rules apply, the UK resident will be treated as if he or she had received the distribution directly from the trust.

The rules apply where the onward gift is made within three years of the receipt of the distribution. However, significantly, there is no time limit in cases where the distribution and gift are part of a planned arrangement. In addition, the rules can apply even if the gift is made prior to (but in anticipation of) the distribution from the trust. Finally, all onward gifts made after 6 April 2017 are subject to the new rules, even if the original trust distribution takes place before that date.

Income tax

The Government has provided an overview of the new income tax regime, and stated that it intends to publish draft legislation no later than the date of publication of the Finance Bill 2017.

Non-UK income

Under the current rules, non-UK source income arising within a non-UK trust, both at trust level and at the level of an underlying non-UK resident company, may be treated as arising to the settlor if he or she is UK resident. In the case of a settlor who is UK resident but non-UK domiciled, the attribution of income is subject to the remittance basis.

Under the new rules, this automatic attribution of income will no longer apply in respect of non-UK income arising in a trust settled by a non-UK domiciliary, even if the settlor subsequently becomes deemed domiciled under the 15/20 year rule. As with capital gains tax, this protected status will be lost if the settlor becomes UK domiciled under general law or property or income is paid into the trust by the settlor (or the trustees of a trust of which he or she is a settlor or a beneficiary) after the settlor becomes deemed domiciled.

If a trust ceases to be protected, and the trust is settlor-interested, the UK resident settlor will be subject to tax on non-UK income as it arises, in the same way as a UK domiciled settlor.
Under the current rules, if non-UK income arising within a trust is invested in the UK by the trustees or an underlying company, this often triggers a deemed remittance by the settlor. Under the new rules, this should no longer be the case, meaning that trustees will be more free to invest in the UK.

UK source income

As under the existing rules, UK source income will continue to be attributable to the settlor if the trust is settlor-interested, and will be taxable as it arises if the settlor is UK resident. UK source income arising at trust level may also be taxable in the hands of a settlor who is non-UK resident.

Benefits received by non-settlor beneficiaries will continue to be taxed as they are under the current rules, but again with some modifications. In particular, as with the provisions for capital gains, benefits received by close family members will be taxable on the settlor if not taxed in the hands of the beneficiary.

Income which has arisen before 6 April 2017 and has been retained in the trust (and not already taxed on the settlor) will be available to be matched with distributions (including those made to the settlor) post-6 April 2017. However, any unmatched distributions made to the settlor before 6 April 2017 will not be matched with income arising within the trust after 6 April 2017.

Valuation of benefits

The response document provides that a new valuation procedure will be introduced for the use of art, chattels, real estate or other assets. By way of example, the proposed valuation for the benefit of the use of art is the official rate of interest (currently 3%) multiplied by the acquisition price, less certain payments made by the beneficiary.

Significantly, it is proposed that where interest-bearing loans are made, but all or part of the interest is rolled up rather than paid, the loan will be deemed to give rise to a benefit equal to the official rate of interest for that year (less any amounts of interest actually paid). Trustees and individuals should, therefore, review their structures to see whether they will be affected by these provisions to ensure that they do not inadvertently incur a UK tax charge.

UK residential properties

Under the current rules, non-UK assets owned by non-UK domiciliaries are not subject to UK inheritance tax as they constitute "excluded property". Excluded property includes the shares in non-UK companies owning UK residential property.

As announced last July, the Government has decided to remove any inheritance tax advantages associated with the use of corporate structures. The draft legislation achieves this by introducing a new definition of "non-excluded overseas property". This encompasses four categories of assets, each of which derives its value from a "UK residential property interest", which is an interest in a UK dwelling (or an interest in a contract for an off-plan purchase of such a dwelling).

The four categories of "non-excluded overseas property" are set out below. The first two categories are straightforward, but the second two are a surprise, and in the event that they are enacted without amendment, will lead to strange results. The second two categories are designed to prevent the use of debt to avoid UK inheritance tax.

A right or interest in a close company

If the value of the right or interest is directly or indirectly attributable to a UK residential property interest, then it is non-excluded overseas property. Therefore, the shares in a non-UK incorporated company which is closely held and owns UK residential property will fall within the scope of inheritance tax. This will be the case even if the residential property is owned through one or more subsidiary companies.

Interest in a partnership

These provisions mirror those dealing with the rights and interests in companies.

Relevant loans

The rights of a creditor who has made a "relevant loan" will constitute a UK asset for inheritance tax purposes (and, crucially, so will an interest in a close company that derives its value from such a loan). A loan is a "relevant loan" if it is used to finance (directly or indirectly):

- the acquisition of a UK residential property interest;
- the maintenance or enhancement of the value of a UK residential property interest; or
- the acquisition of a right or interest in a close company or partnership, if the money was used to finance the acquisition, maintenance or enhancement of a UK residential property interest.

Collateral for relevant loans

If assets are made available as security, collateral or guarantee for a "relevant loan", then those assets will, apparently in their entirety, also be non-excluded overseas property (even if they are owned by a non-UK company or partnership). This will clearly give rise to some very unfair results and it is hoped that the rule will be amended before implementation.

The two year 'tail'

If an interest in a company or partnership is sold after 5 April 2017, and the value of that interest was attributable to a UK residential property interest, then the sale proceeds, regardless of where they are held, will not become excluded property until two years have elapsed. Nothing in the draft legislation suggests that this 'tainted' status will be lost if the money changes hands.

Business investment relief

Business Investment Relief ("BIR") was introduced in April 2012 as a mechanism for individuals taxed on the remittance basis to invest their foreign income and gains in trading activities in the UK without triggering a taxable remittance. However, the complexity of the provisions and the stringent conditions have limited the popularity of the relief. The proposed changes to BIR are, therefore, to be welcomed, although it is hoped that more far-reaching changes will follow as a second round. For now, the following changes will come into effect on 6 April 2017.

- The "extraction of value" rule is one of the restrictions that has caused the most difficulties. Broadly, if an investor receives value (in money or money's worth) from the target company or a company associated with that company, regardless of whether the value is connected with the investment, all of the original income or gains are treated as remitted unless appropriate mitigation steps were taken. These rules will be changed so that they bite only where value is received in circumstances that are directly or indirectly attributable to the investment. The provisions relating to "involved companies" – dealing with value received from an associated company – will be removed. While the new provision is broadly drafted, it should be easier to determine whether it applies and as a result whether relief is available. Unfortunately, the Government has not taken the opportunity to introduce a minimum threshold below which receipts of value by a relevant person would not deny relief altogether.
- Currently, investments can be made only in certain types of company. A new "hybrid" company, essentially one that both trades and invests in other trading companies, will be added to the list of eligible target companies.
- Relief is to be extended to the acquisition of existing shares. This is a welcome expansion and suggests the Government may be open to extending the scope of the relief to investments that may not directly fund the growth of a company's business. In this case, the Government's view may be that selling shareholders are likely to reinvest their sale proceeds in the UK economy thus encouraging a more liquid market. In this respect it is worth noting that shares quoted on AIM are eligible for BIR.
- The Government has been persuaded by arguments that there can be significant delays between investing in a company and that company commencing a trade. The time limit for investing in a company before it starts to trade will, therefore, increase from the current two years to five years. If it turns out that such a start-up company becomes non-operational then the grace period before mitigation steps are required to avoid a tax charge will be extended to two years.

Despite requesting innovative ideas on how BIR might be reformed, the Government has decided to defer consideration of how the scheme could be widened. In addition to calls for the types of eligible investments to be expanded, from government debt through to participation in partnerships, it has been suggested that BIR should be changed so that the investment proceeds could be treated as clean capital after the investments have been held for a suitable period. Given the Government's repeated rejection of suggestions that partnerships be included within the relief, a sceptic might expect the Government to see whether the proposed changes boost the use of BIR to a sufficient extent before considering further amendments. We can hope, however, that the drive for investment in the UK economy post-Brexit means that the extension of BIR will not be put to the bottom of HMRC's in-tray.

Anti-evasion measures targeted at offshore structures

Finance Bill 2017 contains new rules requiring taxpayers to rectify outstanding UK tax liabilities on non-UK source income or non-UK situated assets by 30 September 2018. If they do not, then HMRC will have another four years to investigate such liabilities, with penalties including charges of up to 200% of the "potential lost revenue" (which can be reduced to a maximum of 100% if the taxpayer informs and assists HMRC).

HMRC can generally only investigate unpaid tax within certain limitation periods depending on how serious the offence is. However, if the liabilities are not rectified by the end of September 2018, the new rules would "freeze" them as they stand at 6 April 2017 until 5 April 2021. Until that date, HMRC could continue to investigate such liabilities under the limitation periods that apply on 6 April 2017, which are:

- for income tax and capital gains tax, 2013/14 for innocent errors, 2011/12 for careless errors and 1997/98 for deliberate evasion; and
- for inheritance tax 1997/98 for innocent and careless errors, but with no time limit for deliberate inheritance tax evasion.

It is surely no coincidence that the extra four years that HMRC will have to investigate historic liabilities coincides with the imminent receipt of large amounts of information under the Common Reporting Standard. Accordingly, these rules should be interpreted as a clear indication that HMRC is preparing a comprehensive review of the information it will receive.

Requirement to register offshore structures

The Government plans to consult on requiring "intermediaries" to notify HMRC of "complex structures" that they arrange for their clients to hold their money offshore (together with information on the clients themselves).

We do not have further information other than this brief announcement, which has no suggested timetable or scope. It might be presumed to mirror existing reporting requirements for certain intermediaries, such as for "promoters" of tax avoidance schemes (under the DOTAS rules), but, on the brief wording of the announcement at least, the scope appears far wider. In any event, it is unclear how the information HMRC receives under such a regime would add a great deal to what it already stands to receive under the Common Reporting Standard.

Extension of corporation tax to non-resident companies

The Government announced that it will consult on extending corporation tax to non-UK tax resident companies that incur UK tax on their income. This would replace the existing rules, where non-resident companies, if not trading through a UK permanent establishment, incur income tax on their taxable income at the basic rate of 20%. Given that corporation tax rates are to be lower than the basic rate of income tax (19% from April 2017, and 17% from April 2020), this could be good news for straightforward, non-UK resident company structures (such as a non-UK company, owned by a non-UK resident, owning a UK rental property). Further, non-UK resident corporate groups which are currently prevented from accessing certain reliefs that only apply to corporation tax (such as group relief for losses and expenses) may be able to begin doing so.

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