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Tax Alert

Non-UK domiciliaries and UK residential property:

The draft Finance Bill 2017 reforms

Following the announcement of fundamental changes to the future taxation of non-UK domiciliaries (non-doms) in the Summer 2015 Budget and subsequent consultation and discussions with stakeholders, much of the draft legislation has now been released as part of the draft Finance Bill 2017.

Overview

The Government announced in the Summer Budget 2015 that it would change the tax treatment of long term UK resident non-doms. UK resident non doms who are either long term residents, or who have a "strong connection" with the UK by virtue of being born in the UK and having a domicile of origin here will become "deemed domiciled" for all tax purposes. These changes will come into effect from 6 April 2017 and will be legislated as part of the 2017 Finance Act.

Draft legislation on most of the reforms has now been released and any significant changes from the position as previously understood are discussed here.

The Government acknowledges that the draft legislation is not complete. The major exclusion is the income tax protections applying to offshore trusts, which will be published at or before the date of the 2017 Finance Bill.

The draft legislation published is open for consultation comments until 1 February 2017.

Deemed UK domicile for long-term residents

The core rules in relation to the deemed UK domicile treatment for long term UK residents have not changed substantially since the original consultation document. As expected, non-doms who have been UK resident in 15 of the previous 20 tax years ("long term deemed doms") will be treated as UK domiciled for all tax purposes.

In response to consultation, the Government is shortening the period of non-UK residence required to lose deemed UK domicile status for inheritance tax (IHT) purposes to three full tax years. This mirrors the position under the current law.

The Government is also extending the availability of the remittance basis to temporary non-residents in the year of their return to the UK, in respect of proceeds of gains realised in the non-resident period. This will also be available without payment of a remittance basis charge or loss of allowances.

Transitional reliefs

The draft legislation provides the mechanics for the transitional reliefs previously announced, as follows.

Capital gains tax – April 2017 rebasing

A rebasing to 6 April 2017 value will apply to foreign assets held by an individual who becomes a long term deemed dom on 6 April 2017.

The relief is limited to taxpayers who have paid the remittance basis charge in any year before 6 April 2017. The scope of the relief has been extended slightly since the last consultation in that the asset does not need to have been owned since any particular date, but it cannot have been UK situate at any point in time between 16 March 2016 (or acquisition if later) and 5 April 2017. In order to benefit, the taxpayer must have remained non-UK domiciled at all times since 6 April 2017 and also must have been a long term deemed dom in all tax years from 6 April 2017 until the date of disposal.

Rebasing applies automatically, but can be disapplied by the taxpayer in respect of any specific disposals. This is good news as taxpayers can disapply relief where the 5 April 2017 value of the asset concerned is lower than its acquisition cost.

Finally, the Government has confirmed that rebasing will only apply to assets on which gains would be chargeable to capital gains tax (CGT), so no rebasing will be available in respect of non-reporting offshore funds.

Cleansing mixed funds

Mixed funds (being single funds which consist of any mixture of capital, income and gains) are an issue for non-doms because the taxing rules are complex and generally deem non-doms to have remitted income which would be taxable on them at the highest rates.

The Government had previously announced a one year opportunity to "cleanse" mixed funds by separating them into their constituent parts through transfers into new bank accounts. The draft legislation extends this opportunity to two years starting from 6 April 2017, which is welcome. The draft legislation also confirms, as previously announced, that the mixed fund must take the form of cash in a bank account in order to be cleansed.

In terms of the actual mechanics of the cleansing, in our view the legislation is not totally clear and so we would hope for further clarification before the legislation is adopted.

Now the opportunity has been confirmed, work on determining the constituent parts of mixed funds can begin with a view to planning for future remittances at an early stage.

Inheritance tax on UK residential property

The draft legislation charging IHT on UK residential property has been released. It confirms that the value of an interest in a close company or a partnership will not qualify as "excluded property" from 6 April 2017 to the extent that such value derives from UK residential property.

Originally it was planned that debts relating to such property would not be deductible if owed to a connected person. These proposals have now been altered such that debts can be deductible, but are deemed to be spread across all assets of the company or partnership, even if secured only on the property.

The quid pro quo for the deduction of debts is that loans relating to the financing of the acquisition, maintenance or improvement of a UK residential property (and interests in partnerships and companies that derive their value from such loans) will themselves not be excluded property from 6 April 2017. The legislation seems unfair in this area as, by virtue of taxing 100% of the value of the loan on the one hand but only allowing a deduction for a rateable portion of it on the other, the IHT exposure for taxpayers could actually extend beyond 100% of the value of the residential property. This would seem to go further than the Government intended.

The legislation also confirms that, where property ceases to be caught by the above rules (ie as a result of sale of the property or related asset or repayment of the loan), the property derived from such sale or repayment will continue to be non-excluded property for a further two years.

The draft legislation includes a targeted anti-avoidance rule which disregards any arrangements undertaken wholly or mainly to avoid the charge.

Finally, the draft legislation includes a provision which prevents a double tax treaty from mitigating the IHT charge outlined above in circumstances where there is no estate tax charged in the other country, or it is charged at 0%.

Offshore trust protection

There has been a lot of movement in this area since the last consultation document, although no legislation has yet been produced on the income tax protections for "protected settlements".

For CGT, the draft legislation provides that settlors and beneficiaries will generally be taxed on trust gains when benefits are received, rather than the settlor being taxable on all trust gains as they arise. This treatment is lost however if the settlor, or a trust of which he is a settlor or beneficiary, "taints" the trust by adding any property to it on or after 6 April 2017, unless this property is provided in an arm's length transaction, in pursuance of a pre-6 April 2017 liability, or to fund a shortfall where trustees are unable to meet their expenses from their income.

A major change affecting many offshore trusts is also being introduced, which will apply to all offshore trusts on which the settlor is not taxed immediately on trust gains (ie not just protected settlements). This prevents payments to non-resident beneficiaries being matched to trust gains, unless the payment is to a close family member of the UK resident settlor (in which case separate provisions apply – see more below). This effectively ends the longstanding opportunity that geographically diverse families had to carefully time capital payments such that payments to non-UK residents effectively "washed out" the gains pool of the trust, reducing the level of gains that could be taxed on UK resident beneficiaries.

There are exceptions to this new rule for temporary non-residents (in which case the payment will be matched in the year of return to the UK), and in the year that a settlement ends, where the existing rules will continue to apply (so the gains will be matched proportionally to the payments received).

There is a new charging provision which taxes the settlor in respect of capital payments made to close family members (being their spouse or civil partner, or minor children of the settlor or their spouse/civil partner) where the close family member themselves do not pay UK tax due to non-UK residence or the availability of the remittance basis. The settlor will be entitled to recover any tax paid on such capital payments from the recipient of the payment or from the trustees of the trust without further tax consequences.

There is also a new anti-avoidance rule designed to tax indirect capital payments to UK resident beneficiaries which are not caught by the close family member rule or the existing indirect capital payment provisions. In broad terms this applies where a capital payment is made to a beneficiary that is not a close family member, or at a time when the settlor is non-UK resident (so that no tax charge would arise on this capital payment), and this beneficiary makes an onward gift to a UK resident beneficiary within three years. The time period can be longer if there are "arrangements" in place for someone else to receive the capital payment. It treats the onward gift as though it were a capital payment from the trustees to the eventual recipient at the time of the gift, such that trust gains can be matched to the payment and taxed at that time.

Finally, there is an anti-avoidance provision which prevents the matching of capital payments with gains where the capital payment is made when a beneficiary is UK resident but the gains would be matched in a tax year when the beneficiary has ceased to be UK resident. This is another "anti-washing out" provision, and applies where the year of matching begins on or after 6 April 2017.

The draft legislation also confirms that the transitional protections introduced in 2008 for non-domiciled trust beneficiaries in receipt of capital payments will continue to apply to long term deemed doms, unless and until they become UK domiciled under general law. This means that pre-2008 capital gains and capital payments can continue to be sheltered from capital gains tax, and 2008 rebasing will still apply.

As mentioned above, the major area of the legislation that is missing is the income tax protections for these trusts. The Government have released a response to the further consultation, in which they state that the settlements legislation and the transfer of assets abroad legislation will be dis-applied in respect of foreign income arising in offshore trusts or underlying corporate structures where the settlor is either foreign domiciled or deemed-UK domiciled for tax purposes, and remains foreign domiciled under the general law. Instead, the settlor of such a trust will be taxable on foreign income as and when benefits are received by him or by close family members in circumstances where a tax charge does not otherwise arise. If legislated as set out above, this means that offshore trust structures will continue to be an attractive vehicle in which to roll up family wealth, although their taxation consequences remain complex and so specialist advice is needed.

It is thought that a similar concept of tainting will apply for income tax as for CGT, in that the protections above will not be available where the settlor adds further property, unless one of the exceptions outlined earlier applies.

The Government has also stated that undistributed pre-April 2017 income of a protected settlement or an underlying company will fall into the pool of income taxable on a benefits basis as set out above from April 2017. One possible consequence of this is that the trustees or underlying company may be able to remit such funds to the UK for investment without this triggering a tax charge on the settlor, as the income would no longer be deemed to be his income.

One further trust related issue in the response document is that the Government plans to legislate for a statutory basis of valuing benefits from offshore trusts that are matched to income or gains. This will broadly involve multiplying the amount of a loan to, or the cost of an asset used by, a beneficiary by the official rate of interest (currently 3%) to determine the value of the benefit conferred. A deduction will be allowed for any payments made for use of the asset, but only to the extent that they are paid in the tax year concerned. Thus accrued interest on loans where interest is rolled up will not be deductible until paid and so could give rise to benefit tax charges even if on arm's length terms.

Finally, the Government plans to legislate so that gains representing carried interest (which will have been taxed on the individual performing investment management services) will be excluded from the provisions charging tax on benefits from trusts, on the basis that this would otherwise lead to double taxation.

Other matters

The draft legislation confirmed that foreign capital losses will be available for offset once an individual becomes deemed domiciled, and any foreign loss elections will cease to have effect from that date, although a further election can be made if a deemed domiciled individual becomes non-UK domiciled again through an intervening period of non-UK residence.

Business Investment Relief

The Government has tabled several legislative changes to Business Investment Relief (BIR) in order to make it more attractive to non-dom investors, and have stated that they will consider wider reforms in the future.

The draft measures to take effect from 6 April 2017 are:

- to allow relief for the purchase of existing shares in a qualifying company rather than only new share subscriptions;
- to extend the time limit between the date of investment and the date the company invested in must start to trade from two years to five years;
- to introduce a new type of qualifying company which is a hybrid of a trading company and a stakeholder company (at the moment an investment in a company which does a mixture of the two qualifying types of activity cannot actually qualify for relief);
- extension of the grace period for transfer of funds back offshore when a company has become "non-operational" to two years from when the taxpayer became aware of the issue;
- the reference to an "involved company" has been removed in the extraction of value rules, making the scope of this anti-avoidance rule slightly narrower;
- a company that is a partner in a partnership is not to be treated as trading by virtue of the partnership's activities (this was HMRC's view in any case but is now being made law).

We welcome these changes and hope for further improvements to BIR in the future. In particular one of the issues debated in consultation was whether remitted income or gains could effectively be treated as clean capital after they had remained invested in a qualifying investment for a certain period of time, and this would be a really welcome change and simplification for the BIR rules.

Further information

These wide ranging changes to the UK's tax regime for non-doms mean that those affected will need to review their personal and family's financial positions as well as any offshore structures which will be affected.

Please feel free to get in contact if you would like further information.

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