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APRIL 2017 UK TAX CHANGES: BE PREPARED

MARCH 2017

The UK Government will radically revise the UK tax regime for long-term resident but non-domiciled individuals from 6 April 2017.

These plans have been the subject of considerable consultation and draft legislation for over a year. This private client update provides revisions to our previously published note in December to reflect the Government's publication of further draft legislation and guidance.

The effect of the changes is that permanent non-domicile status will no longer be possible for individuals who have been long-term resident in the UK; those tax resident in the UK for 15 of the previous 20 tax years will become deemed domiciled and be subject to UK tax on their worldwide personal income and gains. Existing deemed domiciled rules for UK inheritance tax (IHT) will also be aligned with this rule so that an individual will be deemed domiciled for inheritance tax purposes once the individual has been UK resident for 15 of the previous 20 years. In addition, UK residential property held by non-UK domiciled individuals through an offshore structure will become subject to IHT.

The publication on 5 December 2016 of the draft Finance Bill 2017, further draft legislation published on 26 January this year, together with the Government's response to public comments on its most recent domicile consultation document (*Reforms to the taxation of non-domiciles: further consultation* published in August 2016) provide most of the details for the implementation of this new regime. Although the reforms will be introduced in less than five weeks, further guidance could still be published potentially at the next Budget on 8 March. This update reviews the new draft legislation and the changes it makes to current proposals including some surprising and far reaching amendments which will have unexpected consequences for trusts and individuals who may have thought themselves unaffected by the amendments to date.

THE DRAFT FINANCE BILL 2017 AND DOMICILE STATUS

On 5 December the Government published its draft Finance Bill 2017 (Finance Bill), together with comments on several relevant ongoing tax consultations. Its proposals outlined in *Reforms to the taxation of non-domiciles (response to further consultation)* (Consultation Paper) are of particular importance. The significant changes apply to non-domiciled individuals who will become deemed domiciled on 6 April 2017; to settlors and beneficiaries of non-UK trusts; and to trustees and individuals who own UK residential property through offshore structures or who have made loans available to individuals or trustees to acquire or maintain UK residential property.

Key points to be aware of include:

- for IHT purposes, deemed domiciled status is now lost after leaving the UK and residing abroad at the start of the fourth tax year of non-residence;
- for capital gains tax (CGT) purposes rebasing will not be available to persons who become deemed domiciled after 6 April 2017, but consider whether actual rebasing can occur before an individual becomes deemed domiciled;
- the time period for segregation of mixed accounts has been extended from one to two tax years;
- how benefits received from an offshore trust will be valued; the Consultation Paper suggests that the Government intends to introduce a fixed valuation method for valuing intangible benefits from trusts, such as loans or the use of art and property;
- trusts making loans or additions to another trust could taint a trust and cause the recipient trust's protected status to be lost; and
- for those who choose to remove a UK residential property from an offshore structure (otherwise known as 'de-enveloping') there will be no tax relief on the de-enveloping.

Given that the reforms are due to be introduced within weeks, advisors and non-domiciled individuals have very limited time to deal with the implications. We are happy to advise and discuss any concerns you may have.

DEEMED DOMICILED PROVISIONS AND THE FINANCE BILL

The Consultation Paper now refers to these changes as "deeming provisions". It confirms that:

- permanent non-domiciled status will no longer be available for individuals who have been long-term tax resident in the UK. Once an individual has been UK resident for 15 of the previous 20 tax years, they will become deemed domiciled and be subject to the same tax regime as UK domiciliaries; and
- for all taxes 'returning non-domiciliaries' (those now non-domiciled individuals who were born in the UK with a UK domicile of origin) coming back to the UK will no longer be able to claim non-domiciled status (with limited exceptions).

The Consultation Paper announced an important change to the original proposals. For IHT purposes, deemed domiciled status will be lost after leaving the UK and residing abroad at the start of the fourth tax year of non-residence.

The period of time required before deemed domiciled status can be lost for income tax and capital gains (CGT) purposes remains unchanged at six years. These rules will not apply to individuals who cease to be resident prior to 6 April 2017 and relevant individuals may wish to consider taking advice on their residence position prior to that date.

CGT: Rebasing of offshore assets

The Finance Bill and Consultation Paper confirm that deemed domiciled individuals will receive the benefit of rebasing for directly held foreign assets to their market value on 5 April 2017. The relief is only available to those who have paid the remittance basis charge in any year before 6 April 2017. It also applies on an asset by asset basis.

Both documents also confirm some important details with regard to these proposals:

- rebasing will not be available for persons who become deemed domiciled *after* 6 April 2017;
- rebasing will not extend to gains in trusts (as discussed below, gains in trusts for deemed domiciled individuals will be subject to a different regime);
- for rebasing to apply the asset must not be situated in the UK between 16 March 2016 to 5 April 2017 (the "relevant period"); and
- the rebasing will apply automatically to a relevant person unless an election is made (on an asset by asset basis) to disapply the rebasing.

An amendment to the rebasing provisions published in the 26 January draft legislation means that rebasing will apply to non-reporting offshore funds.

Although this relief will only apply to a relevant individual on a disposal after 6 April 2017, it is a potentially generous relief and individuals should consider if they do not already qualify whether it would be advantageous to consider paying the remittance basis charge for one tax year in order to qualify for this rebasing. Individuals should also consider whether to arrange contemporaneous valuations now for relevant assets to be used where assets are disposed of after April 2017.

Mixed funds

For those holding mixed funds (those that contain elements of income or gains) in overseas bank accounts, the Finance Bill and Consultation Paper have confirmed that segregation of those funds will be possible for a limited period. Funds may be allocated into separate accounts to ensure the element of clean capital can be remitted into the UK without a charge to tax arising. In addition, it has also been announced that:

- the time period for segregation of accounts has been extended from one to two tax years commencing on 6 April 2017;
- a nomination must be made to qualify for the transfer and the transfer must be made into a separate receiving account;
- the provisions will only apply to balances held in bank accounts.

OFFSHORE TRUSTS AND THE FINANCE BILL

The Government has confirmed in the Consultation Paper that it will introduce an alternative taxing regime for offshore trusts that are created before an individual becomes deemed domiciled in the UK. The Finance Bill provided draft legislation in relation to capital gains tax, and the income tax provisions were provided on 26 January 2017. Although the changes represent a significant departure from the existing regime, and one which requires trustees, non-domiciled settlors and beneficiaries to consider planning prior to 6 April 2017, the impact of the changes in most cases will be less severe than was originally anticipated.

Updated legislation is being introduced as a result of the new deemed domiciled provisions which mean that a previously non-domiciled settlor will no longer be able to claim the remittance basis in relation to income and gains which arise within an offshore trust structure once he becomes deemed domiciled in the UK. Broadly, under current rules income which arises in an offshore trust structure will be treated as that of a UK resident settlor. A tax liability does not arise in relation to foreign income if a non-domiciled settlor claims the remittance basis of taxation (although UK source income remains taxable). Income which is not taxed as the settlor's is available to be matched to distributions made to UK resident beneficiaries of the trust (including the settlor), but again subject to an election for the remittance basis. Capital gains which arise within an offshore trust structure are not matched to a non-domiciled settlor (although would be matched to a UK domiciled settlor). Instead those stockpiled gains are matched to distributions made to beneficiaries of the trust, whether or not UK resident. A non-domiciled beneficiary may elect for the remittance basis to apply if he does not remit the distribution to the UK. Accordingly, if the current rules remained unchanged, the new deemed domiciled provisions would unfairly affect a previously non-domiciled settlor after the introduction of the changes on 6 April 2017.

Offshore trusts and the Finance Bill: income tax changes

The 26 January 2017 draft legislation provides substantial revisions to the taxation of offshore trusts. Grandfathering provisions for offshore trusts created before a settlor becomes deemed domiciled in the UK allow for a protected status to apply to the relevant trust. Details on how protected status may be lost are set out below.

The 26 January draft legislation proposes that a liability to income tax in relation to a relevant offshore trust which benefits from protected status will only now arise to the extent that benefits are received from that trust; such changes will apply to all offshore trusts created by non-UK domiciled individuals (not just those who become deemed domiciled). In relation to a protected status trust, the draft legislation also provides that:

- foreign income arising from 6 April 2017 to an offshore trust will not be treated as income of the settlor (such income is known as "protected foreign source income"). Trustees will be able to consider bringing protected foreign source income to the UK without incurring a taxable remittance for the settlor;
- protected foreign source income will only be taxed on a deemed domiciled settlor by reference to the benefits received by them or close family members (spouses and minor children) where those benefits are not already subject to income tax in the hands of the recipient (for example if the settlor's spouse is non-UK resident it will still be taxed on the settlor);
- foreign income arising before 6 April 2017 will be available to match to benefits received on and after 6 April 2017 – however it is not clear whether such income will no longer be treated as the settlor's. If it is still treated as the settlor's consider distributing this income out of the trust now to avoid the risk of a future taxable remittance;
- foreign income of a non-UK company held by a trust will also be protected foreign source income; such income will not need to be paid up to the trustees as a dividend within a specified period to ensure that it receives protected status (as was previously suggested);
- UK source income will continue to be taxed as the settlor's income on an arising basis. If this is not possible (because for example, the settlor is dead or non-UK resident) then it will be taxable on a beneficiary according to their status when a benefit is received;
- UK source income which has already been taxed as the settlor's income will be protected and will

not be subject to income tax if distributed after 6 April 2017; and

- where a distribution is made to a non-UK resident or non-UK domiciled beneficiary who makes a gift to a UK resident in the year of distribution or during the following three tax years (or over a longer period if part of an arrangement), the ultimate recipient in the UK will be treated as if they had received the gift directly from the trust and will be taxed on any income in the trust structure which can be matched against the benefit. This anti-conduit rule mirrors that introduced for capital gains tax purposes (detailed below).

Offshore trusts and the Finance Bill: CGT changes

Where protected status applies to an offshore trust, CGT will only be charged to the extent that benefits are received from the trust. As is currently the case, gains will continue to be stockpiled within a trust and will be matched against benefits received. However, the provisions now mean that a settlor is more likely to be subject to tax when a capital payment is made and not otherwise subject to tax, but this is preferable to earlier consultations which had suggested the settlor would pay CGT on an arising basis. The Finance Bill and Consultation Paper also states:

- capital payments made to a settlor or a close family member will be taxable as the settlor's on an arising basis dependent on their tax status;
- beneficiaries will be subject to a CGT charge if they receive a capital payment to which stockpiled gains are matched and where they are resident and domiciled, or resident and non-domiciled and remit the payment to the UK;
- capital payments made to non-resident beneficiaries who then make gifts to UK residents within three years of the original appointment (or over a longer period if this is part of an arrangement) will be subject to tax as though the distribution from the trust was directly to the UK resident recipient;
- close family members include a spouse and minor children but not minor grandchildren; and
- capital payments made to a non-resident on or after 6 April 2017 will not ordinarily be matched against any gains held within the trust regardless of the settlor's domicile or whether the payment is made to the settlor or another beneficiary. This "anti-avoidance" provision means that gains can only be offset against capital payments to UK resident beneficiaries unless it is a distribution made in the year of the termination of the trust. This is a significant departure from the previous proposals.

Protected status for trusts

Protected status is only available for an offshore trust created before a settlor becomes deemed domiciled. It effectively means that a settlor will not be taxed on retained income or gains of an offshore trust provided the trust is not tainted. Tainting will occur if an addition is made to the trust after the settlor has become deemed domiciled in the UK with some limited exceptions.

An addition by someone other than the deemed domiciled settlor will not taint the trust, but an addition from another trust (from which the settlor can benefit) will taint the trust. Care must be taken with regard to making loans or appointments between trusts, as these may taint the trust and cause protected status to be lost. Protected status will be lost permanently where property or income is paid into the trust although property added as part of an arms-length transaction will not cause protected status to be lost. HMRC have confirmed that such tainting would occur in cases where any benefit is provided and would, for example, include an interest free loan to the trust.

Protected status only applies to offshore trusts and not to directly held offshore companies or directly held investments. Accordingly, those non-domiciled individuals who hold investments, whether personally or in offshore companies, and who become deemed domiciled on 6 April 2017, should consider whether to transfer those assets into an offshore trust prior to 6 April 2017. From this date they will not be able to claim the remittance basis and will be taxable on those income and gains on an arising basis. The assets will also form part of their estates for IHT purposes which would not be the case if settled onto a trust prior to becoming deemed domiciled (except for UK situated property held through an offshore trust).

Valuation of benefits

The Consultation Paper sets out new proposals detailing how benefits will be valued where beneficiaries receive an intangible benefit such as those from using art and a property. Draft legislation has not yet been provided, but it is proposed that the Government will introduce a fixed valuation method for calculating a benefit received based on an official rate of interest for particular circumstances.

INHERITANCE TAX ON UK RESIDENTIAL PROPERTY HELD THROUGH OFFSHORE STRUCTURES

The Government has announced in previous consultations that UK residential property held in offshore structures (typically held by an offshore company owned by a trust) will be subject to IHT. Such property will no longer be classified as non-UK situated on the basis that the company would effectively be transparent for IHT purposes and the value of the residential property attributed to the shareholder including trusts and individuals.

The legislation published on 5 December 2016 as part of the draft Finance Bill 2017 imposes an IHT charge on three categories of property:

- interests (for example, shares) in closely held companies which directly or indirectly derive their value from UK residential property;
- an interest in a partnership, the value of which is directly or indirectly attributable to UK residential property; and
- loans used by individuals, trustees or partnerships to finance the acquisition, maintenance or enhancement of UK residential property, or loans used by individuals or trustees to invest in a close company or partnership which uses the funds to acquire, maintain or enhance UK residential property. Collateral used for these loans will also be caught and subject to IHT.

In addition, where property to which the new rules apply has been disposed of (for example, shares in a company which holds UK residential property are sold), or a loan caught by the rules is repaid, the proceeds of sale of that disposal or repayment will remain relevant property for IHT purposes for two years from the date of disposal or repayment.

In determining the value of shares in a company which will be subject to IHT, any debts of the company will be attributed to all of the property and other assets held by the company proportionately (regardless of whether that debt would otherwise be attributed to any particular property of the company). This is less of a concern if the company's sole asset is a UK residential property and has incurred borrowing to finance the acquisition, but if the company has other assets, only part of the debt will be deductible from the value of the UK residential property.

The effect of these changes on UK residential property owned in a trust/company structure will mean that the trust will be subject to the relevant property regime and IHT 10-yearly charges and exit charges at a rate of up to 6% will apply to the value of the relevant property. Trustees of settlor-interested trusts which were previously excluded property for inheritance tax purposes will also need to consider whether the gift with reservation of benefit rules apply to the value of the residential property held within the trust. Where a double taxation treaty exists, such charges will only apply where the other relevant jurisdiction does not have an effective tax in place which would subject the property to a charge.

In the context of recent years' changes to the taxation of UK residential property (such as the introduction of the Annual Tax on Enveloped Dwellings (ATED) and Non-Resident Capital Gains Tax, the announcement that UK residential property held through non-UK structures will be brought within the scope of IHT will affect many individuals and trusts. The previous changes introduced often put non-UK domiciled individuals in the position of having to choose between paying ATED and the IHT protection afforded by non-UK structures, and many chose to accept the ATED charges and retain the IHT benefits. Those IHT benefits will now disappear and there are various potential pitfalls to be wary of.

Although previous consultations had confirmed the Government's intentions to introduce legislation which applies IHT to interests in residential property held through offshore companies, the breadth of the rules to include loans and other interests had not been anticipated. These provisions will apply in a number of cases and, in addition to reviewing existing corporate ownership of residential properties, individuals and trustees will also need to consider whether any existing loan arrangements may need to be examined.

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What are the options?

Individuals and trustees should review their structures now to determine whether it is advisable to maintain the existing structure or whether some form of restructuring should take place prior to 6 April 2017. In some cases, if a property is being let on a commercial basis and an ATED-relief claimed, the costs of de-enveloping may outweigh the costs of leaving the structure in place. However, where ATED applies, the additional exposure to IHT means that in some cases an alternative structure, for example direct personal ownership or trust ownership, may be more attractive.

The position of any loans (and any collateral used for such loans) in a structure should be reviewed and perhaps removed or replaced with commercial debt where possible. Trustees, partnerships and company directors will need to consider where any loans have been made whether those loans may have been used to finance the acquisition, maintenance or enhancement of UK residential property.

Historic information should also be gathered, for example valuations for relevant dates, and income and stockpiled gains in the trust, to determine the costs of de-enveloping.

If you would like to discuss the issues raised in this update please contact your usual property contact or a member of our private client team who would be pleased to help.

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FIND OUT MORE

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