GOWLING WLG

REFORMS TO THE TAXATION OF NON-UK DOMICILED INDIVIDUALS: DRAFT LEGISLATION AND FINAL PROPOSALS

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On Monday 5 December 2016, the Government published long-awaited draft legislation for the reform of the taxation of non-UK domiciled individuals, together with its response to the results of a consultation on the proposed measures published in August 2016 ("response document").

The draft legislation includes provisions to bring into the scope of inheritance tax (IHT) UK residential property held by non-domiciliaries through offshore companies and other entities, together with provisions introducing new deemed domicile rules for long-term UK residents and individuals born in the UK with a UK domicile of origin.

At the links below, we review each of the proposed new measures and note where changes have been made to earlier proposals. We also touch on some planning options in each case for individuals who may be affected by the reforms, which the Government has confirmed will be introduced with effect from April 2017.

Summary of the measures

- Non-UK domiciled individuals will no longer be able to shelter UK residential property from IHT by holding it through an overseas company or other overseas vehicle.
- Non-UK domiciled individuals with a domicile of origin outside the UK will be deemed to be domiciled in the UK for all tax purposes - income tax, capital gains tax (CGT) and IHT - after they have been UK resident for 15 out of the last 20 tax years.
- Individuals born in the UK with a UK domicile of origin will be unable to take advantage of a subsequently acquired foreign domicile at any time when they are UK resident (referred to as a 'formerly domiciled resident').

IHT on indirectly held UK residential property

- With effect from 6 April 2017, shares in certain offshore companies and offshore partnerships will no longer qualify as "excluded property" under relevant IHT legislation, to the extent that their value is derived from UK residential property.
- Diversely held vehicles holding UK residential property will be out of the scope of the new charge, but closely held offshore companies or partnerships will be within the rules.
- The provisions will extend to certain debt arrangements.

Chargeable events

- IHT will be imposed on the occasion of a chargeable event. Relevant chargeable events would include the death of an individual who owns the company shares, the re-distribution of the company share capital or the ten year anniversary of a trust, among others.

Valuation

- Detailed draft valuation provisions have not yet been published, but the intention is that where an estate owns shares in an offshore company which in turn owns UK residential property, the estate will be within the charge to IHT to the extent of the open market value of the underlying property.
- Further details of how this will work in more complex circumstances (for example, where ownership of a property is shared between a number of overseas companies) are still required.

Debts

- In the August consultation, the Government proposed that debts between 'connected parties' would be disregarded when calculating the value of the property for IHT purposes. Following criticism of this proposal, it has reconsidered.
- A debt (including a connected party debt) will be allowable against the value of an estate that holds a UK residential property. However, under the new rule, if the loan is taken out to acquire or maintain a UK dwelling, it will be treated as within the charge to

IHT in the hands of the lender.
- There is no indication in either the response document or the draft legislation as to whether there will be any grandfathering for loans made pre-April 2017.

Disposals

- A new rule has been introduced, the intention of which, according to the response document, is that when a UK residential property held through an overseas company is sold, the proceeds of sale will be within the scope of IHT for two years following the disposal.
- However, the draft legislation appears to go further than this, potentially catching disposals of shares and interests in partnerships, repayments of relevant loans and disposals of a property on liquidation of the overlying company. There is a separate rule in respect of property held via trusts.

Anti-avoidance

- A targeted anti-avoidance provision has been included to prevent arrangements being put in place to secure a tax advantage by avoiding or mitigating the IHT charge.

Liability and accountability

- This will principally fall on executors, trustees and beneficiaries. A proposal made in the consultation to impose an additional liability on directors of a company that owns UK residential property has been dropped.
- HMRC's existing powers to impose a charge on UK properties will be extended to include UK residential property that is liable to an IHT charge under the new provisions. Such a charge would prevent a sale of such a property until an outstanding IHT liability has been paid.
- The Government is continuing to consider other options for enforcing an outstanding IHT charge.

Transitional arrangements

- Disappointingly, the Government has re-confirmed its decision not to offer transitional arrangements to mitigate the tax costs of those who might wish to unwind structures.

Planning points

- For many individuals, the costs of maintaining a holding structure with virtually no remaining tax advantages will mean that de-enveloping to hold the UK residential property directly will become attractive. Unfortunately, there will be no reliefs available to mitigate the tax costs of doing so, although it may be possible to make some tax savings through careful re-structuring.
- The new rules regarding disposals of UK residential property, whereby consideration in money or money's worth will be within the UK IHT net for two years following the disposal, will require careful consideration, particularly in the situation where a re-structuring involving the liquidation of an offshore company may be envisaged.
- Existing debt arrangements should be reviewed before the new rules come into force.
- For an individual wishing to invest in UK residential property generally, rather than in any specific property, investing in a diversely held fund or non-resident company that holds such property may be an alternative tax-efficient option, as the new provisions will not apply to diversely held entities.
- UK commercial real estate held within an offshore structure is another alternative that may become more attractive in future, as may other forms of UK situate non-residential property or foreign property.

Deemed UK domicile for long-term UK residents (whose domicile of origin is outside the UK)

- Non-UK domiciled individuals with a domicile of origin outside the UK will be deemed to be domiciled in the UK for all tax purposes after they have been UK resident for 15 out of the last 20 tax years (15/20 year rule). As a result, they will be subject to global taxation on an 'arising basis'.
- Such individuals will be able to lose their deemed domicile status again and "reset the clock" for income tax and capital gains tax (CGT) purposes once they have spent six consecutive tax years resident outside the UK. For IHT purposes, the required period of non-residence is to be four tax years, but if the individual becomes UK resident within six tax years of leaving, he will be within the scope of IHT again.
- The new rules will not affect an individual's domicile status under general law, nor the

domicile status of any of their children, which will be determined according to the child's individual circumstances. However, years spent in the UK while an individual is under the age of 18 will count for the purposes of deemed domicile.

Impact of changes on the remittance basis charge

- From 6 April 2017, the £90,000 annual charge to claim the remittance basis for individuals who have been resident in the UK in at least 17 of the past 20 tax years will be redundant, because such individuals will by then be taxed on the arising basis. The £30,000 charge (for UK residence in at least seven of the past nine tax years) and £60,000 charge (for UK residence in at least 12 of the past 14 tax years) will remain unchanged.

Transitional rules

Mixed funds

- Individuals with 'mixed funds' in overseas bank accounts consisting of foreign capital, capital gains and income will be able to separate them into their constituent parts. This option will be available to all non-domiciled individuals not born in the UK with a UK domicile of origin, regardless of their residence at April 2017. The period of time in which funds can be cleansed has been increased from one year from April 2017 to two years.

Rebasing

- It will also be possible for non-domiciled individuals who become deemed domiciled in April 2017, and who dispose of a relevant asset on or after 6 April 2017, to rebase such an asset to its market value as at 5 April 2017. The protection will be limited to assets that comply with certain conditions regarding ownership and foreign situs. Where assets were purchased wholly or partly with foreign income or gains, the remittance basis will be available for the element of the disposal proceeds that relates to such income or gains.
- The protection will be limited to those who had paid the remittance basis charge in any year before April 2017.

- It will be possible for an individual to elect for rebasing not to apply to a disposal. Any such election will be irrevocable.

Protection for property in non-UK resident trusts

- Property in non-UK resident trusts settled by non-domiciled individuals before they become deemed domiciled in the UK will be outside the IHT net as excluded property, to the extent it is non-UK situate property, or is UK situate property (apart from residential property and certain loans) held by the trustees through a non-UK vehicle (e.g. a company).

Taxation of income and gains in respect of non-resident trusts

- The response document and accompanying draft legislation sets out rules for the protection of existing non-resident trusts and for the taxation of income and gains on payment of benefits and capital payments from a trust which differ significantly from earlier proposals.
- The rules proposed in the August consultation appeared particularly harsh in the case of CGT, where the trust protection was to fall away permanently if a relevant beneficiary received a benefit from the trust. In this situation, the UK deemed domiciled settlor would in future be taxed on all gains arising in the trust or attributable to the trustees in the same way as a UK domiciled settlor.
- Following discussions with practitioners, and having considered responses to the consultation, the Government has made changes to both the proposed CGT and income tax provisions. The new rules are noteworthy because they will affect not only deemed domiciled settlors, but also non-UK domiciled settlors who have not yet acquired deemed domicile status.

Capital Gains Tax

- Under the CGT provisions, a UK resident settlor will be liable to tax according to their tax status on trust gains matched to a capital payment received from the trust, together with any payments made to "close family members" unless the close family member is themselves taxable as a result of being UK resident and either UK domiciled or deemed domiciled, or non-domiciled but having remitted the payment to the UK in that tax year.

- A "close family member" is defined as a spouse, civil partner, co-habitee or minor child. The definition does not include a minor grandchild.
- There will be a right of reimbursement from the trustees or beneficiary where a settlor has been taxed in respect of a benefit paid to a close family member.
- Trust gains matched to a capital payment made to a beneficiary who is not a close family member will be taxed according to the status of the beneficiary.

"Washing out" gains to non-residents

- A new rule has been introduced at the same time for all non-resident trusts under which a capital payment made to a non-UK resident beneficiary (whether the settlor or otherwise) of a trust on or after 6 April 2017, or one that is matched after that date, will no longer be matched against the pool of trust gains.
- This will prevent the so-called "washing out" of trust gains, whereby they can be matched with a capital payment to a non-UK resident beneficiary. Under existing rules, having been washed out in one tax year, such trust gains would be unavailable for matching with a potentially taxable payment made to a UK resident beneficiary in a subsequent tax year.

Income Tax

- A similar set of rules is to be introduced for income tax, whereby a settlor will only be taxed according to their tax status on foreign trust income to the extent that he or a close family member receives a benefit from the trust and provided the close family member is not themselves liable to tax.
- UK source income is broadly to be taxed on the basis of the existing rules.
- Details of the proposed rules will be published in the Finance Bill 2017, most likely in March 2017.

Transitional rules

- There will be transitional rules governing the way in which pre-April 2017 foreign income will be matched after that date and how pre-April 2017 benefits or capital payments will be taxed in different situations. These are yet to be published.

Tainting protected settlements

- The CGT and income tax protections discussed above for non-resident trusts established by a settlor before he becomes deemed domiciled will be lost completely if property or income is added by the settlor to the trust during a period in which the settlor is deemed domiciled.
- An addition made during such a period by the trustees of any other settlement of which the settlor is a settlor or beneficiary will also taint the recipient trust.
- Once a trust is tainted and the protections lost, trust gains and foreign income will in future be taxed on an arising basis on the deemed domiciled settlor while he is UK resident.

Recycling benefits from protected settlements

- The Government is concerned that beneficiaries who are not close family members and are either non-resident or are remittance basis users, could agree to hold money received from a trust for a period of time and then give or lend it back to a beneficiary in the UK who would otherwise be taxed on it. The UK resident beneficiary could then receive the payment from the trust without paying tax on the distribution.
- As a result, it is introducing a rule to ensure that where payments are made from a trust to such a beneficiary who makes a gift (which includes any benefit) to a beneficiary in the UK within the following three years, the payment will be taxed on the UK resident beneficiary.
- In the event that the onward payment is made as part of arrangements for the payment made by the trustees to be received ultimately by the final beneficiary rather than the original recipient, the rule will apply without the three year time limit.

Valuations

- Following representations for some clarification as to how the benefit to a beneficiary of a capital payment made up of different assets should be valued, the Government is going to introduce a set of rules which will apply across the CGT and income tax benefits charges.

Planning points

- Offshore trusts are likely to have an increasingly important place in the planning of non-domiciled individuals intending to come to the UK for a period, as it appears that there will be a number of tax advantages to holding property within such a structure, apart from UK residential property. These include the continuing ability to shelter non-UK assets and certain UK assets from IHT, as well as the ability to defer, and potentially avoid, tax on foreign income and gains (other than from disposals of indirectly held UK residential property) arising in a trust, provided the non-domiciliary and relevant members of his or her family do not benefit from the trust during a period of deemed domicile.
- Nevertheless, the new regime may result in an increased tax burden and more onerous record-keeping in some situations. Accordingly, it will be vital for trustees and settlors to take advice before making or (in the case of the settlor) receiving distributions in case there may be tax implications for the settlor and, more generally, to understand all the potential consequences of the new regime.
- Non-domiciled individuals who are approaching 15 tax years of residence in the UK may wish to consider leaving the UK for a period in order to restart the clock on deemed domicile, particularly bearing in mind that the Government has refused to consider any grandfathering provisions. A period of non-residence of at least six consecutive tax years will be required for an individual to achieve this.
- The Government's concession with regard to cleansing mixed funds is potentially beneficial. Any non-domiciled individuals (apart from formerly domiciled residents) who have such funds should consider taking advantage of the two year window to segregate the constituents of their overseas accounts for the future. This segregation will be important even once an individual is UK deemed domiciled.
- Where possible, and after careful consideration of their specific circumstances, settlors and trustees of non-resident trusts with significant levels of trust gains, may wish to consider making distributions to non-resident beneficiaries before 6 April 2017 in order to wash out such gains while it is still possible to do so.

Non-UK domiciled individuals born in the UK with a UK domicile of origin

- No changes have been made to the proposed rules which are to apply to formerly domiciled residents. They remain as they were set out in the August consultation, as discussed below.

- Individuals born in the UK with a UK domicile of origin who subsequently acquire a foreign domicile of choice will be treated for tax purposes as if they are UK domiciled once they become UK resident.
- While they are UK resident, they will be subject to tax on their worldwide income and capital gains on the arising basis, as would a UK domiciled individual.
- While they are treated as UK domiciled, they will also be subject to IHT on their worldwide estate. However, there will be a grace period for individuals who only return to the UK for a short period so that they will not be treated as domiciled in the UK for IHT purposes at any relevant time unless they have been so resident for at least one of the two tax years prior to the tax year in question.
- Any non-resident trust established by such an individual prior to 6 April 2017 while non-UK domiciled, or after that date while they are domiciled and resident outside the UK, which would qualify as a relevant property trust if the settlor was UK domiciled, will be taxed as such for IHT purposes during any period in which they are UK resident and/or treated as UK domiciled, and will be subject to ten year anniversary and exit charges.
- Unless the settlor is excluded from all benefit from a trust, rules relating to 'gifts with a reservation of benefit' ('GROBs') will apply to treat the trust property as remaining in the settlor's estate for IHT purposes, and taxable as such on his or her death while UK resident or treated as UK domiciled.
- The IHT grace period will also be available for non-resident trusts.
- Ten year anniversary charges will be apportioned based on the settlor's period of UK residence during the last ten years, and there will be no exit charge if and when the settlor leaves the UK, and assuming they remain non-UK domiciled under the general law.
- On departure from the UK, such individuals will cease to be treated as UK domiciled on becoming non-UK resident unless they have been UK resident for 15 out of the last 20 tax years or have ceased to be non-UK domiciled under the general law. In either or both of those cases, the relevant rules and periods of non-residence for losing an actual or deemed domicile will apply.

Planning points

- Formerly domiciled residents will be in a significantly less favourable tax position from April 2017 than individuals whose domicile of origin is elsewhere. Their treatment will be broadly comparable with those who are UK domiciled under the general law (at

least during their period of residence and, in some cases, for a number of years afterwards).
- The remittance basis of taxation will no longer be available to formerly domiciled residents, regardless of their period of residence in the UK.
- It will remain possible for such individuals to establish excluded property trusts while they are non-resident in the UK (as long as they have been non-resident for a sufficient period to lose their deemed domicile for IHT purposes). However, careful consideration will be needed in each case as to whether such trusts provide genuine advantages.
- Individuals who are in this position, and who are considering leaving the UK anyway in the near future, may wish to do so before 6 April 2017 in order to avoid potentially being caught by the new rules.
- Following the introduction of these new rules, appropriate tax planning for a formerly domiciled resident may take a form closer to that for a UK domiciled individual, including ISAs, offshore life bonds and, for IHT purposes, the use of reliefs for business property and agricultural property.

General comments

- The proposed new rules will clearly have significant impact on non-UK domiciled individuals, particularly formerly domiciled residents. Some of the new provisions will affect individuals positively. However, there are a number of new provisions, not least the proposed anti-avoidance rules and those relating to loans in respect of UK residential property, that may be unhelpful and will require early and careful consideration.
- It is disappointing that the Government has decided to make a number of significant changes and additions to previously proposed measures so close to the introduction of the new legislation. Furthermore, we still await large sections of the new legislation and the details of many of the new proposals are not fully clear.
- It is also disappointing that the Government has refused to reconsider its position on transitional relief to assist individuals who wish to re-structure their holdings of UK residential property in advance of the introduction of the new IHT charge. The tax costs of re-structuring will be a significant deterrent for some of those who might otherwise have wished to do so.
- Nevertheless, for those who do wish to consider some form of re-structuring, advice should be taken as soon as possible. This would also be sensible for anyone who may be caught by the new deemed domicile provisions, whether as a formerly domiciled

resident or otherwise, especially if they may be considering a period of non-residence or taking advantage of transitional provisions where they are available.

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