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UK Summer Budget 2015 – new rules for non-doms

Individuals domiciled outside the United Kingdom (UK) might have been justified in thinking that they would be safe from significant changes in this Summer's Budget on 8 July. However, despite the recent introduction of ever increasing charges to qualify for the remittance basis and additional tax charges on residential property owned by non-residents, the UK Chancellor had further measures to announce in his Summer Budget to target perceived unfairness in the treatment of foreign domiciled individuals compared with those domiciled in the UK.

These measures include the following:

- 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 inheritance tax (IHT) - after they have been resident for 15 out of the last 20 tax years;

- Individuals 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, irrespective of the number of years they spend here;

- Non-UK domiciled individuals will no longer be able to shelter UK residential property from IHT by holding it through an offshore company or other offshore vehicle. This will apply to property held through companies owned by both individuals and trustees.

In this note, we look at the new measures, which are due to take effect from 6 April 2017 following consultations to be published later in the summer, and consider the potential implications for non-UK domiciliaries, both resident and otherwise.

We also make some suggestions for possible planning in advance of the introduction of measures where this may be relevant, bearing in mind that the form and scope of the measures may change substantially during the consultation process.

Domicile and the existing tax treatment of non-domiciled individuals

For those for whom it would be useful, a brief reminder of the general rules of domicile within the UK, and the existing tax treatment of non-UK domiciled individuals, may be found in the Appendix.

The new measures

Individuals whose domicile of origin is outside the UK

- With effect from 6 April 2017, individuals with a domicile of origin outside the UK will be deemed to be UK domiciled for all tax purposes after they have been resident in the UK for 15 of the past 20 tax years. This includes IHT, for which the existing period of residence for an individual to be treated as UK domiciled is 17 out of the 20 tax years ending with the relevant tax year.

- Accordingly, from the start of an individual's 16th tax year of residence, they will be unable to claim the remittance basis of taxation for income tax and CGT purposes and will be taxed on the 'arising basis' on their worldwide income and gains. They will also be subject to IHT on their worldwide estate.

- The Budget technical paper indicates that the consultation will raise the issue of whether split tax years of UK residence will count towards the 15 tax years for the purposes of the rule or whether complete tax years of UK residence will be required. If split years do count, it may be possible for an individual to become deemed domicile after only 13 tax years and 2 days rather than a full 15 tax years.

- The new rules will not affect an individual's domicile status under general law.

- The new rule, referred to as the "15 year rule" in the technical paper published as part of the Budget, will also not affect the domicile of any children of the individual. Their domicile status under the general law and for tax purposes will be determined according to their own individual circumstances. The paper would appear to be contradictory in respect of the general law as it also states that a child will continue to inherit his or her domicile of origin from their father at birth. However, a child will not become or cease to be deemed domiciled in the UK simply because a parent has. The child's own length of UK residence will be the deciding factor.

- From 6 April 2017, the £90,000 annual charge to claim the remittance basis for individuals who have been resident in the UK in 17 out of 20 tax years will be redundant, as such individuals will by then be taxed on the arising basis.

- The £30,000 charge (for seven out of nine tax years' residence) and £60,000 charge (for 12 out of 14 tax years' residence) will remain unchanged.

- The Government proposes to consult on the need to retain a de minimis exception in cases where an individual has been UK resident for at least 15 tax years where total unremitted foreign income and gains are less than £2,000 per annum.

- The new rules will apply with effect from 6 April 2017 irrespective of when an individual arrived in the UK. There will be no 'grandfathering' of the existing rules for those already in the UK. For those who leave the UK before 6 April 2017 but who would nevertheless be deemed domiciled under the 15 year rule on 6 April 2017, the present rules will apply.

- Once a non-domiciled individual leaves the UK and spends more than five tax years outside the UK, he or she will lose their deemed domiciled status for tax purposes. In practice, while they continue to be non-UK resident, this will only be relevant for IHT purposes as such individuals are not liable to UK tax on their foreign income and worldwide gains anyway unless they return to the UK within five tax years of leaving.

- After having spent more than five tax years abroad so as to lose their deemed domicile, a non-domiciled individual will be able to spend another 15 tax year period as a UK resident before again becoming deemed domiciled. During this period they will be able to claim the remittance basis of taxation for income tax and CGT and will only be subject to IHT on their UK assets (subject to a proposed change in the IHT rules relating to residential property discussed below).

Application of new rules to non-resident trusts

- The paper indicates that non-UK domiciled individuals who have set up an offshore trust before becoming deemed domiciled under the 15 year rule will not be taxed on trust income and gains that are retained in the trust while they are deemed to be domiciled, and excluded property trusts will retain the same IHT treatment as at present (again, subject to the proposed new rule for the taxation of UK residential property discussed below).

- However, long term residents who are deemed to be UK domiciled will from 6 April 2017 be taxed on benefits, capital or income received from any trusts on a worldwide basis.

Planning points for long term residents whose domicile of origin is outside the UK

- While at first glance, the new 15 year rule for non-domiciled individuals without a UK domicile of origin appears to be a severe curtailing of the tax advantages of that status, under the current proposals it is not as detrimental as it first appears. There has been a deemed domicile rule for long-term UK residents for many years in relation to IHT (albeit based upon 17 tax years of residence rather than 15 tax years until now) and it is not a great surprise that one has now been introduced for income tax and CGT.
- 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, other than UK residential property, within such a structure. These include the continuing ability to shelter non-UK assets from IHT, as well as the ability to defer, and potentially avoid, tax on income and gains arising in a trust provided the non-domiciliary does not benefit from the trust during a period of deemed domicile.
- As the technical paper is drafted, the position may even be more generous in future than at present, as currently a settlor may be taxed on income or gains from any trust in which they have an interest, irrespective of whether they actually receive any benefit from the trust.
- Nevertheless, 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. The technical paper refers to spending 'more than five tax years abroad' to achieve this. The new rules are not yet clear, but if they work in a similar way to the existing rule for IHT deemed domicile, a period of non-residence of at least six tax years will be needed for an individual to lose their deemed domicile.
- As highlighted above, depending how the Government decides to treat split years of residence, it may be necessary to review carefully how and when this may affect an individual's tax status for the purposes of the new rules taking such years into account.

Non-UK individuals with a UK domicile of origin

- The Government indicated in the Budget that it wishes to make it harder for individuals whose domicile of origin was in the UK, but who subsequently acquire a different domicile of choice, to claim non-UK domicile status for tax purposes if they subsequently return to the UK.

- Accordingly, an individual with a UK domicile of origin will be deemed to be UK domiciled for tax purposes on any occasion on which they are resident in the UK, even if under the general law they have acquired a different domicile. Thus, they will not be entitled to claim the remittance basis of taxation during any period of UK residence.

- On departure from the UK again, such an individual will be able to lose their status as deemed UK domiciled in the tax year following departure. However, this will only be the case if both of the following conditions are satisfied:

  - the individual has not spent more than 15 tax years here, and

- the individual has not acquired an actual domicile in the UK under general law during his or her period of return.

- If the first of the two conditions applies, an individual will be subject to the new 'five year rule' requiring five tax years' non-UK residence in order to lose their deemed domicile status.

- If the second condition applies, the individual will be subject to the existing 'three year rule' for IHT purposes whereby an individual does not cease to be deemed domiciled in the UK until at least three years have passed since they were domiciled in the UK under the general law.

- If both conditions apply, the individual will be subject to the both the five year rule and the three year rule and can lose their UK domicile status for tax purposes only on the occurrence of the later of those events.

Application of new rules to non-resident trusts

- Such individuals who are non-UK domiciled under general law will be able to set up excluded property trusts on the same basis and with the same tax benefits as any other non-domiciliary, while they are non-UK resident. If they subsequently return to the UK, however, they will not benefit from any favourable tax treatment in respect of such trusts, while they are resident here whether IHT treatment or otherwise.

- Accordingly, it would appear that such individuals who return to the UK will be taxed on capital gains and income arising in an offshore settlement under applicable anti-avoidance rules, in some cases even if they do not receive any benefit from it and they will no longer be able to take advantage of the remittance basis while such income or gains remain outside the UK.

General application

Once again, it appears that there will be no grandfathering in relation to these rules. They will affect all former UK domiciliaries from 6 April 2017, even those who returned to the UK prior to that date. The five year rule will affect any former UK domiciliary who leaves the UK after 5 April 2017. It seems that the rules will also apply to trusts set up at any time while the individuals were non-UK domiciled if they are UK resident on or after 6 April 2017.

Planning points for non-UK domiciled individuals with a UK domicile of origin

- Individuals with a UK domicile of origin who return to the UK for a period of time will be in a less favourable tax position from April 2017 than those whose domicile of origin is elsewhere. In many ways, therefore, their treatment will be comparable with those who are UK domiciled under the general law (at least during their period of residence and for up to five tax years afterwards).
- Unlike those with a foreign domicile of origin, the remittance basis of taxation will no longer be available to them regardless of their period of residence in the UK.
- However, 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 under the five year rule or three year rule, or both). This will continue to be sensible IHT planning in many cases as it will allow assets in excess of the nil rate band (currently £325,000) to be put into trust for future generations without an immediate IHT charge at the lifetime rate of 20%. In addition, it appears that provided the individual is not deemed domiciled at the date of any chargeable event for IHT purposes (on a ten year anniversary, for example), non-UK assets in the trust (including UK assets, apart from UK residential property, held within an underlying offshore company or similar vehicle) will be protected from an IHT charge as excluded property.
- 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, including, for longer term residents, the five year rule for losing a deemed domicile

- Following the introduction of these new rules, appropriate tax planning for a 'returning' non-domiciled individual 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.

Consultation and legislation

- In many areas, all of the rules discussed above for non-domiciliaries will require interaction with other existing tax rules such as the anti-avoidance rules relating to the taxation of income and gains in offshore trusts. With regard to these and other interactions, for example, with relevant estate duty treaties, potential issues will be included in the proposed consultation to take place after the summer Parliamentary recess, and most likely in early September.

- Legislation is anticipated for the Finance Bill 2016.

New IHT rules for UK residential property held within offshore corporate envelopes

- With effect from 6 April 2017, UK residential property will be within the scope of IHT whether it is held directly or indirectly by non-UK domiciled individuals in the same way as property owned by UK domiciled individuals.

- The Government only intends to change the existing IHT rules for UK residential property. The rules as they relate to other UK or foreign property, will be unchanged.

- The measure will apply to UK residential property of any value and irrespective of whether it is occupied or let. The Budget paper indicates that the new rules for indirectly held residential property will be based on the rules for the annual tax on enveloped dwellings (ATED) levied in respect of property held through a non-natural person, such as a company, partnership with one or more corporate partners or common investment fund. However, the ATED threshold whereby the tax only applies to property over a certain value (£500,000 with effect from 1 April 2016) and its reliefs (for example, for property let on a commercial basis) will not be applicable.

- The definitions of UK residential property and persons to be chargeable will be broadly the same as those used in the new CGT legislation introduced for non-residents disposing of UK residential property from 6 April 2015, with any necessary adaptations. Thus, the charge is likely to apply to 'property used or suitable for use as a dwelling'.

- According to the Budget paper, diversely held vehicles holding UK residential property will be out of the scope of the new charge, but closely held offshore companies, partnerships or similar structures will be within the rules.

- IHT will be imposed on the value of UK residential property owned by an offshore company or other vehicle on the occasion of a chargeable event. Such chargeable events will include:

  - The death of an individual who owns the company shares;
  - A gift of the company shares into trust;
  - The ten year anniversary of the trust;
  - Distribution of the company shares out of trust;
  - Death of a donor within seven years of making a gift of the property holding company shares to an individual;
  - Death of a donor or settlor who benefits from the gifted UK property or shares within seven years prior to his death. The reservation of benefit rules will apply to the shares of a company owning UK property just as they currently apply to UK property held by foreign domiciliaries and generally to UK domiciled individuals. These rules provide that a donor of property who continues to benefit from it, although he or she had purported to have given it away, is treated as still owning that property for IHT purposes.

- Legislation will be changed so that shares of offshore companies or other vehicles will not be excluded property to the extent that they derive their value from UK residential property or to the extent that such shares are otherwise attributable to UK residential property.

- The Budget paper recognises that UK residential property may not be the only asset owned by an offshore company. It may also hold foreign assets or UK assets other than residential property that are not be subject to the charge. Also companies may be held in more complex structures, such as groups. Furthermore, the non-domiciled individual or excluded property trust may not be the only owner of the company. The Government intends to consult on the details of the proposed measures with a view to making sure that only the value of UK residential property is subject to tax (less any borrowings taken out to purchase such property).

- The proposals envisage that the same reliefs and charges will apply as if the property was directly owned by the relevant individual. Thus, the spouse exemption will be available to the owner of shares who leaves them to a spouse/civil partner. It will not generally be available where the shares are held in trusts other than qualifying interest in possession trusts or where the settlor is taxed on them at death under the reservation of benefit rules.

- It is intended that liability, reporting and enforcement, and targeted anti-avoidance provisions will be included in the legislation. As yet, there is no detail on the likely rules in this regard.

- As with the proposed new rules relating to deemed domicile, there is to be a consultation in respect of the proposals towards the end of the summer, but in this case, with a view to legislation in the Finance Bill 2017.

- The consultation will address issues such as costs associated with de-enveloping structures so that individuals hold residential property directly. Such costs may be significant, for example, where properties have been mortgaged or have increased in value since April 2013 or April 2015 (when ATED-related CGT and then the wider CGT charges, were respectively introduced).

<u>Planning points</u>

- These new measures will come as a blow to many non-UK domiciled individuals holding UK residential property through corporate envelopes. Over the last two tax years, we have seen the introduction of the Annual Tax on Enveloped Dwellings (ATED), ATED-related CGT and non-resident CGT (where this is also relevant). If they have purchased residential property through a corporate structure, they may also have suffered Stamp Duty Land Tax at the higher rate where the property was valued at over £2 million, or more recently, over £500,000. The one tax advantage of holding residential property through a corporate structure that remained was the shelter provided from IHT, and now this too is being withdrawn.
- For some individuals, the non-tax advantages of holding property through a structure may still outweigh the tax disadvantages. These include confidentiality of ownership and asset protection, and the potential avoidance of forced heirship rules, whether Sharia or civil law based.
- One key non-tax advantage of holding property through a structure is the avoidance of the need for UK probate on the death of an individual where the property owned is shares in an offshore company rather than the underlying UK property. This may no longer apply from April 2017, if a grant of probate in some form is required, albeit possibly in relation to the shares in the company. What the position will be in this regard, exactly how and where a liability to IHT will fall where property is not owned by an individual directly, and how it will be paid and enforced, will be a matter for consultation
- In relation to such an IHT charge, assuming the deceased's personal representatives are primarily liable for the tax, there may be a secondary liability for the company or the recipient of the property under the deceased's estate if the personal representatives do not pay the IHT themselves. HMRC may also take a charge on the underlying property if the tax is not paid. Since the introduction of ATED, HMRC has more information on offshore companies holding UK property than would previously have been the case. However,

taking such a charge may be an issue for HMRC in situations where there is a mortgage of more than 60% of the value of the property.

- For some, perhaps many, individuals the costs of maintaining a holding structure will mean that de-enveloping to hold the UK residential property will become attractive. We await the consultation to see whether the government will provide an incentive to individuals to de-envelope by mitigating some of the costs of doing so. Certainly, there is an indication in the way the Budget paper is worded that the Government may at least consider options for some form of mitigation.
- Where an individual decides to de-envelope a property and own it directly, there continue to be options available to mitigate IHT, one of which is insurance.
- Lower value properties held directly may fall within a couple's joint nil rate bands. This is currently £325,000 each or £650,000 jointly. However, an additional nil rate band will be available for property used as a main residence passed on death to direct descendants. This will start in tax year 2017/18 (increasing from £100,000 initially to £175,000 in 2020/21) and any unused nil-rate band will be available to be transferred to a surviving spouse or civil partner who dies on or after 6 April 2017, regardless of when the first death occurred.
- There will be a tapered withdrawal of the additional nil-rate band for estates with a net value of more than £2m, at a rate of £1 for every £2 over this threshold. However, no additional IHT mitigation may be necessary if there are no other significant UK assets and the net value threshold only applies to property within an individual's taxable estate under the new rules when they are introduced.
- Alternatively, property may be purchased with a mortgage to reduce its value in a non-domiciled individual's estate. Legislation introduced in 2013, which restricts the deductibility of liabilities for IHT purposes in certain circumstances, may limit the effectiveness of such a strategy where the relevant legislation applies.
- 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 invests in such property, may be an alternative tax-efficient option, as it appears that the new provisions will not apply to diversely held entities.
- It is also worth bearing in mind that UK commercial real estate held within an offshore structure will not be caught by the new IHT rules under the proposals. Neither will other forms of UK situate non-residential property or foreign property.
- For non-UK domiciliaries who are also non-UK resident, forms of UK property other than residential property may still be tax efficient as they are not within the scope of non-resident CGT, or, where applicable, ATED or ATED-related CGT.

Conclusion

The new measures are clearly far reaching and will represent a fundamental change in the taxation of non-domiciled individuals from 2017, particularly those with a UK domicile of origin, for whom the benefits of that status will be severely curtailed if they return to live in the UK.

They will also represent a final nail in the coffin for the tax advantages of holding UK residential property in corporate structures. Nevertheless, there continue to be other benefits that may still make such structures worthwhile depending on individual circumstances.

In any event, given that our current understanding of the proposed measures is based solely on brief technical papers accompanying the main Budget documents, clearly we do not have sufficient details yet to draw any conclusions that would enable concrete planning decisions to be made. Furthermore, it is quite likely that changes may be made to the existing proposals before the legislation comes into force.

Nevertheless, it is useful to consider what options may be available to non-domiciled individuals who are likely to be affected by the new measures. We will report further on the proposals as they develop during the process of consultation and, subsequently, once draft legislation is available. In the meantime, non-domiciled individuals who may be thinking of either leaving or coming to the UK in the next few years, or of investing in UK residential property, should ensure that they take advice on what planning steps, if any, may be appropriate on the basis of the developing proposals.

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APPENDIX

Domicile and the existing tax treatment of non-domiciled individuals

Domicile - general principles

- Under the general legal principles of the countries within the UK, an individual acquires a **domicile of origin** at their birth. This is usually the domicile of their father at the time but, in certain circumstances, for example if an individual's parents were unmarried at the time of his or her birth, he or she may acquire their domicile of origin from their mother.

- A domicile of origin can be displaced by the acquisition of a **domicile of dependency** if the domicile of an individual's father or mother, as relevant, changes while the individual is under the age of 16 years.

- From the age of 16 years, an individual can acquire a **domicile of choice** if they live in a country other than that of their domicile of origin and intend to remain there permanently or indefinitely.

- An individual may lose a domicile of choice in a country by leaving it without intending to return there, and moving to another country without forming an intention to live in that country permanently or indefinitely. In that situation, his or her domicile of origin will revive unless and until the individual replaces it with a new domicile of choice.

- None of these rules are changing as a result of the Budget announcement.

Existing tax treatment of non-UK domiciled individuals

<u>Income tax and capital gains tax</u>

- An individual who is resident but not domiciled in the UK pays tax on their UK income and capital gains as they arise (the 'arising basis'), in the same way as a UK domiciled individual.

- Such an individual may claim the 'remittance' basis of taxation in respect of their income and gains outside the UK. In this case, they will only pay UK tax on such income and gains if they 'remit' them to the UK.

- For short term UK residents, there is no charge to claim the remittance basis. Once an individual has been resident in the UK in 7 out of 9 tax years (subject to a de minimis exception), an annual fee applies of £30,000 per annum, in addition to any tax due on remittances. Once an individual has been resident in 12 out of 14 tax years, the annual charge increases to £60,000 and, after 17 out of 20 tax years, the annual charge increases to £90,000.

- A non-UK domiciled individual who is a settlor and/or beneficiary of a non-UK trust is entitled to claim the remittance basis in respect of any income or gains arising in the trust on which they would otherwise be liable to UK tax, whether as a result of a distribution or otherwise.

<u>Inheritance tax</u>

- A non-UK individual is subject to IHT on their UK situate assets but not on any assets they own outside the UK. However, once a non-domiciled individual has been resident in the UK in at least 17 of the preceding 20 tax years ending with the relevant tax year, he or she is treated as 'deemed' domiciled in the UK for IHT purposes only.

- A previously UK domiciled individual who acquires a domicile of choice elsewhere continues to be treated as UK domiciled for IHT purposes for three years after he or she ceases to be UK domiciled under general law, the 'three year rule'.

- A non-UK domiciled individual can establish an 'excluded property trust'. Such a trust will be outside the scope of inheritance tax to the extent that the property held within it is situate outside the UK. This continues to be the case in respect of property settled into trust while the settlor was non-domiciled, even if the settlor subsequently becomes UK domiciled (whether for IHT purposes or generally).

- UK situate property, such as residential property, for example can be taken out of the scope of IHT by holding it through a non-UK company or similar vehicle. In this situation, the non-domiciled individual or trustees of a trust own the shares in the company rather than the underlying UK situate property.

Ends
