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CHARTERED ACCOUNTANTS

REFORM OF THE NON-DOM REGIME - DECEMBER 2016

Introduction

On Monday 5 December 2016, the government released the final outcome of the consultation on the reforms to the UK tax regime for individuals who are not domiciled in the UK ("non-doms") from April 2017 onwards.

The package of reforms was originally announced at the Summer Budget 2015, and the consultation followed a two-step process. The first consultation ran from September 2015 to November 2015, and this latest "further consultation" commenced in August 2016.

The conclusion to the consultation has been long-awaited, and it has wide-reaching implications for many non-doms; most notably those who have been living in the UK for some time ("long term residents") and those with overseas structures.

Alongside the consultation response, the government has published most (although not all) of the draft legislation which will be included within Finance Bill 2017 to bring the rule changes into effect from 6 April 2017.

Even though the legislation has been issued in draft and there is still more to come, the overall intention of the reforms is now clear and non-doms should be taking advice without delay. We have summarised the key points below.

Deemed domicile for long term residents

From 6 April 2017, non-doms who have been resident for at least 15 out of the previous 20 tax years will become deemed domiciled in the UK for all tax purposes. This is referred to as the "15 / 20 test".

There are two important tax consequences arising from becoming deemed domiciled in the UK:

1. For income tax and capital gains tax purposes the remittance basis will be unavailable to individuals who become deemed domiciled under the 15 / 20 test from 6 April 2017.

The result will be UK taxation on worldwide income and gains; regardless of whether the income or gains arise abroad or are remitted to the UK.

2. For inheritance tax ("IHT") purposes the worldwide assets of an individual who becomes deemed domiciled under the 15 / 20 test from 6 April 2017 will be within the scope of IHT.

Currently there is a 17 out of 20 year deemed domicile rule for inheritance tax, so the new rule will shorten the time period during which non-UK assets fall outside the IHT net. It is worth remembering that IHT applies to lifetime gifts as well as on death.

The government published the draft legislation for the 15 / 20 test as part of the earlier (September 2015) consultation. However, stakeholders raised concerns over the length of time it would take for an individual to lose their deemed domiciled status for IHT after leaving the UK. In response, the draft legislation has been amended.

An individual who leaves the UK will lose deemed domicile status for IHT from the start of their fourth consecutive tax year of non-residence. This effectively aligns the position for those leaving the UK after April 2017 with that under the existing (17 out of 20 year) rule.

A longer period of non-residence will be required for individuals who are caught by the 15 / 20 test and who are aiming to fall outside the new deemed domicile rules upon returning to the UK after April 2017 (often referred to as re-setting the domicile "clock"). Six complete tax years of non-residence will be required, and it will also be necessary for the individual to retain their non-UK domicile as a matter of general law.

Long term resident non-doms who will become deemed domiciled on 6 April 2017 will be impacted most by these changes and they should seek professional advice without delay. The options open to non-doms need to be considered as soon as possible, as they may take time to implement before April 2017.

Deemed domicile – individuals born in the UK with a UK domicile of origin

Such individuals will be deemed domiciled from 6 April 2017 while they are UK resident, even if they have acquired a non-UK domicile under general law. Unlike individuals who become deemed domiciled because they are long term residents, "returning UK domiciliaries" will be unable to benefit from the following transitional arrangements.

Transitional arrangements

The government has sought to soften the immediate impact of deemed domicile for long term resident non-doms by introducing two transitional reliefs, outlined below.

Rebasing foreign assets

Individuals who become deemed domiciled under the 15 / 20 years test on 6 April 2017 will be able to "rebase" foreign assets to their April 2017 market value for capital gains tax purposes, if certain conditions are met. Rebasing provides a tax-free uplift in base cost.

Specifically, the individual needs to have paid the remittance basis charge at least once; either for 2016/17 or an earlier tax year. The legislation also confirms that rebasing will not be available on a rolling basis to individuals who become deemed domiciled in tax years after 2017/18.

It should also be noted that rebasing will only apply to non-UK assets which are directly held by the individual as at 6 April 2017, meaning that trust or company-owned assets will not qualify for rebasing. Assets where gains on disposal are subject to income tax, such as certain offshore fund investments which do not have "reporting status", are also excluded from rebasing.

Where rebasing applies, it may be possible to sell an asset shortly after 5 April 2017 without realising a significant gain. The after-tax sale proceeds could then be brought to the UK without a further tax charge, unless the asset was originally purchased with untaxed foreign income or gains.

Rebasing will apply on an asset by asset basis. The individual will be able to opt out of rebasing for a particular disposal by making a formal election to HMRC no later than four years after the end of the tax year of the disposal.

Unless such an election is made, rebasing will apply to all personally held non-UK assets owned on 5 April 2017, as long as the asset has been situated outside the UK for the entire period between 16 March 2016 (or the date of acquisition if later) and 5 April 2017. The location of the asset is most likely to be relevant for moveable assets, e.g. art and antiques etc.

Cleansing mixed funds

The draft legislation confirms that there will be a two-year window in which to re-arrange ("cleanse") mixed funds, between 6 April 2017 and 5 April 2019. This is a welcome extension to the one-year window initially proposed by the government.

In contrast to rebasing, the cleansing opportunity will be available to all non-doms (apart from those born in the UK with a UK domicile of origin) regardless of how long they have been UK resident, or whether the remittance basis charge has been paid.

The concept of a mixed fund may be familiar to some non-doms and alien to others. In short, a mixed fund is an overseas bank account containing a mixture of capital, unremitted foreign income and/or unremitted foreign gains. Once a mixed fund is created it is difficult, under the current rules, for a non dom to remit their tax-free "clean" capital to the UK, as the taxable income and gains would usually be deemed to have been remitted in priority.

Importantly, the cleansing provisions will provide a valuable opportunity for non-doms to identify and access clean capital within a mixed fund, which can then be used to finance their UK expenditure free of tax. Similarly, it is an opportunity to access foreign capital gains which might be remitted in preference to income in order to attract a 20% tax rate rather than income tax rates of up to 45%.

The government has confirmed that cleansing will only apply to cash held in an overseas bank account. It will not apply to financial or other assets representing mixed funds. However, it will be possible for an individual to sell an asset and cleanse the proceeds once paid into an overseas bank account.

Cleansing is likely to be most beneficial for non-doms who are running out of clean capital, particularly those who have been living in the UK for many years or have stayed here longer than expected. It will also be an opportunity to unravel mixed funds created unintentionally or through a lack of planning.

In view of the complex nature of the rules, we recommend that advice should be taken before attempting to cleanse a mixed fund account. Where an account has been in existence for some time, or there are many transactions, a time-consuming historical analysis may be required in order to quantify the clean capital.

Changes to tax treatment of non-UK trusts

The draft legislation and consultation response confirmed the tax treatment of overseas trusts from 6 April 2017 onwards. Both the income tax and capital gains tax regimes for overseas trusts will be changed, with certain "protections" for trusts settled by a deemed domiciliary prior to becoming deemed domiciled.

Although the draft legislation for the capital gains tax treatment of overseas trusts has been published, the legislation for the income tax treatment of overseas trusts may not be available until April 2017. Even so, the government's response provides an overview of both regimes. We have summarised the key points below.

Capital gains tax

From 6 April 2017 the foreign capital gains of an overseas trust will be attributed to the settlor (and taxed on them) personally if they are deemed domiciled and they, or certain family members, are able to benefit from the trust. This is referred to as the "settlor charge".

However, there will be an exemption from the settlor charge for "protected" overseas trusts.

- Any non-dom will be able to settle a protected overseas trust before 6 April 2017, regardless of how long they have been UK resident (although the inheritance tax implications would need to be considered).

- Overseas trusts settled on or after 6 April 2017 will also have protected status, as long as the settlor is not yet deemed domiciled at the time of settlement.

Settlors of protected trusts who subsequently become deemed domiciled will only be taxed on trust gains if, and to the extent that, they receive a benefit from the trust. This is preferable to being taxed on trust gains as they arise.

For some non-doms, there is a final opportunity to create an overseas trust before 6 April 2017 without being caught by the settlor charge under the new regime.

Importantly, the protected status of the trust will be lost if the trust is "tainted" by the settlor adding assets to the trust (on or after 6 April 2017) at a time when they are deemed domiciled.

Direct and indirect additions of assets will taint the trust, and particular care will need to be taken over transactions between trusts, as the addition of assets by another trust related to the settlor may also jeopardise the protected status of the trust.

Wide-reaching "anti-avoidance" rules have also been introduced, which will prevent planning involving the provision of trust benefits to close family members or non-resident beneficiaries with the aim of either avoiding a tax charge for the settlor or "washing out" the pool of taxable gains within the trust.

The government will also introduce rules to ensure that, where a payment is made by a trust to a non-resident individual or remittance basis taxpayer who then gives or lends the money to a UK resident beneficiary within 3 years, the payment will be taxed on the UK resident beneficiary.

Income tax

Although no draft legislation has been published yet, the government has outlined the intended income tax treatment of overseas trusts from 6 April 2017. These proposals may be subject to further consultation.

The broad principle is that foreign income arising in overseas trusts (and underlying corporate structures) settled by a non-dom will not be taxed on the settlor once they become deemed domiciled under the 15 / 20 test. The same "opaque" tax treatment for foreign income will apply equally where the settlor remains non UK domiciled.

Instead, non-domiciled and deemed domiciled settlors will only be taxed on foreign income arising in the structure if, and to the extent that, they receive a benefit from the trust. The remittance basis may prevent a tax charge if the settlor is non-domiciled and the benefit is received outside the UK, but deemed domiciliaries will be taxable on benefits received worldwide.

It is expected that similar provisions to those for capital gains tax will be introduced to ensure that the favourable income tax treatment for foreign trust income will be lost if the settlor makes additions to the structure after they become deemed domiciled. Similar anti-avoidance rules to those described above for capital gains tax will also be introduced.

UK source income will be taxed on the settlor on an arising basis if the settlor (or their spouse) is able to benefit from the trust.

Valuing trust benefits

The government intends to introduce statutory valuation rules for trust benefits, which will apply for both income tax and capital gains tax purposes.

These rules will cover the use of trust assets. For example, it is suggested that the benefit of the use of art will be valued by multiplying the acquisition price, less any payments made by the beneficiary for the use of the art (including payments for insurance and storage) by HMRC's official rate of interest, which is currently 3%.

New provisions will also ensure that a loan is deemed to give rise to a benefit even under arrangements where interest is rolled-up rather than paid by the beneficiary on a regular basis.

The new valuation rules will impact benefits provided from 6 April 2017 onwards, including benefits initially received before 6 April 2017 which continue after that date.

Carried interest

The consultation response indicates that the offshore trust protections for foreign income and gains will not extend to receipts of carried interest.

It is anticipated that offshore trusts will effectively be treated as being transparent for tax purposes, such that settlors who become deemed domiciled under the 15 / 20 year test will be taxed on carried interest payments on an arising basis.

IHT treatment of UK residential property held within non-UK structures (enveloped properties)

The draft legislation makes it clear that UK residential property held through close companies and partnerships will be subject to IHT from 6 April 2017.

Under the new rules, an interest in a foreign close company or partnership will no longer be outside the scope of IHT to the extent that its value derives directly or indirectly from UK residential property. As a result, all individuals and trusts will potentially be liable to IHT from April 2017 onwards if they own UK residential property, regardless of how the ownership is structured.

The new rules are broad, and they will apply even if an individual or trust has no connection to the UK other than an underlying interest in a UK residential property. They will also apply to all events on which IHT could potentially be chargeable; including lifetime gifts, transfers on death or trust IHT charges.

There will be circumstances in which the proceeds received on the sale of a UK residential property interest may continue to be within the scope of IHT for two years after the disposal date. As a result, IHT charges might arise even where UK residential property is no longer held.

It has been confirmed that the definition of a "dwelling" will follow the definition currently used for non-resident CGT purposes. Only the use of the property at the time of the chargeable transfer will be relevant for determining whether IHT applies.

Loans, including loans from connected parties, used to acquire or maintain a UK dwelling will reduce the value for IHT purposes. However, the draft legislation contains new provisions treating the value of such loans as subject to IHT in the hands of the lender. These rules will apply to all loans from 6 April 2017(not only those made between connected parties) and, again, there are provisions catching the value of loans repaid for up to two years after the repayment date.

In addition, collateral provided as security (e.g. an overseas investment portfolio) for a loan used to acquire UK residential property will also be subject to IHT.

Rules for valuing UK property interests held in complex structures will be published as part of the draft 2017 Finance Bill.

Business Investment Relief

Business investment relief (BIR) is a relief which enables non-doms who are taxed on the remittance basis to remit what would usually be taxable overseas funds (income and gains) to the UK for the purpose of investing in a UK business without incurring a tax charge, provided certain conditions are met.

Since the relief was initially introduced in April 2012, it has not stimulated UK investment to the extent the government had hoped. In Autumn Statement 2015 the government committed to consulting on the ways in which BIR could be improved in order to make the relief more attractive to non-doms, whilst still safeguarding against abuse of the relief.

The government's consultation response confirms that they intend to change the existing rules in the following ways, with effect from April 2017:

- Currently BIR is withdrawn in relation to a particular investment in the event that the investor receives a benefit from the target company or any company associated with it. The legislation will be revised to ensure that an incidental benefit received from a company associated with the target company does not result in a breach of the BIR conditions. Instead, there will only be a breach if a benefit is received and it can be linked back, directly or indirectly, to the investment.

- Under the present rules a company either has to be a trading company or a stakeholder company investing in one or more trading companies. The new rules will introduce the concept of a "hybrid" company, enabling investment in

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a company that is acting as both a stakeholder company, and trading in its own right, to attract BIR.

- There will be a relaxation of the existing time-limit for a company beginning to trade once an investment has been made, and the grace period for taking mitigation steps to avoid a tax charge if a company becomes non-operational will also be extended.

- The new rules will also permit the investor to acquire existing shares in a qualifying target company, rather than newly issued shares only.

The government has confirmed that it is prepared to consider further measures to widen the appeal of BIR in future Finance bills. However, it reaffirmed that investments in corporate members of trading partnerships will continue to be excluded from the relief unless the company is carrying on a commercial trade in its own right.

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