TAX CHANGES FOR NON-UK DOMICILIARIES

DRAFT FINANCE BILL 2017 | 14 FEBRUARY 2017 UPDATE

CONTENTS

INTRODUCTION

After a seemingly never ending period of uncertainty, with two budgets, autumn statements and formal consultations, at long last we now have the draft Finance Bill 2017 together with further draft legislation published in January 2017, containing the changes to the taxation of non-UK domiciled individuals. The Bill will be effective from 6 April 2017.

Despite pressure to delay the proposals, particularly following Brexit, the Government's project to reform the tax rules for non-UK domiciled individuals (non-doms) will now be implemented.

The announcement makes clear that the Government's aspiration for a tax system that "balances fairness and international competitiveness" remains the same.

While many of the changes are in line with those previously put forward, there are some new points to be aware of which, for some taxpayers, will be welcomed, but there may be a sting in the tail for the unwary. It is gratifying to note that the Government has listened to professional advisers and, particularly in the field of offshore trusts, has relaxed some of its initial proposals considerably. BDO, along with others, have been in close dialogue with the Government in trying to ensure that the proposals put forward are fair but, at the same time, reminding of the value that non-doms bring to this country.

THIS UPDATE COVERS THE FOLLOWING PROPOSALS:

- The new deemed domicile 15 out of 20 years (15/20) rule
- Rebasing for offshore assets for individuals who become deemed UK domiciled on 6 April 2017 under the 15/20 rule
- A grace period to unravel or 'cleanse' offshore mixed fund bank accounts
- The proposals to charge UK inheritance tax on UK residential property held indirectly through an offshore entity
- Protections and reforms for offshore trusts
- Making Business Investment Relief more accessible.

DEEMED UK DOMICILE

The Government has issued its response to the August 2016 consultation and has published draft legislation, effective from 6 April 2017.

THE NEW 15/20 RULE

From 6 April 2017, any non-dom individual who has been resident in the UK in at least 15 of the past 20 tax years (including split years) will become ‘deemed’ UK domiciled for income, capital gains and inheritance tax (IHT) purposes. In other words, for the first time long term non-doms will be taxable on a worldwide basis.

Such individuals will no longer be able to use the remittance basis for future offshore income and gains arising after the date they become deemed domiciled (ie 2017/18 and subsequent tax years for those becoming deemed domiciled on 6 April 2017). Prior income and gains will remain taxable if remitted into the UK. Both offshore and UK assets will be subject to UK IHT when the taxpayer is deemed UK domiciled.

The new deemed UK domicile status will commence from the 16th year of UK residence (years of residence during childhood will count). In establishing years of UK tax residence, the tax rules in place for the relevant year will be used, meaning the statutory residence test can only be used from 2013/14 onwards.

A non-dom does not have to have had 15 consecutive years of residence in order to be caught by the deemed domicile rule - two or more spells of residence might need to be counted. However, once deemed domiciled, non-doms who leave the UK but who return after six tax years will start a new period of up to 15 years during which they can be resident in the UK without being deemed UK domiciled, provided they have not acquired a domicile of choice in the UK.

It is worth noting that if a non-dom leaves the UK to become non-resident prior to 6 April 2017 and does not return then they will not be subject to the new rules.

For capital gains tax purposes, where an individual disposes of an asset whilst temporarily non-resident (in some cases this can apply where the individual is non-resident for fewer than six years) and returns to the UK in a year where the 15/20 rule applies, the full gain would become taxable regardless of whether the funds are brought to the UK. However, for individuals who were non-resident before the original announcements on 8 July 2015, there will be a transitional rule enabling them to claim the remittance basis for disposals made in the temporary non-residence period to prevent an automatic tax charge in the year of return.

For IHT purposes only, the rule has now been aligned with current legislation in that if a deemed UK domiciled individual ceases to be UK resident, deemed domicile status is lost after three consecutive tax years of non-UK residence. However, if they return in years four, five or six, the 15/20 rule will apply for all taxes from their return (but see below for individuals born in the UK).

If such an individual returns to the UK before six tax years are completed, the 15/20 rule will apply for all taxes from their return.

Where a non-dom transfers or gives away offshore assets before they are deemed UK domiciled, the original transfer will remain excluded property for IHT purposes even where the individual is deemed UK domiciled on death.

SPECIFIC MEASURES FOR THOSE BORN IN THE UK WITH A UK DOMICILE OF ORIGIN – FORMERLY DOMICILED RESIDENTS

The reforms restrict access to non-dom status for individuals who were born in the UK with a UK domicile of origin (“formerly domiciled residents”) but who later acquired a domicile of choice elsewhere.

1. From 6 April 2017, such individuals will be treated as UK domiciled for all tax purposes at all times if they are already resident or if they are non-resident but later come to the UK and become resident (subject to a grace period for IHT – see below).
2. Trusts that are established offshore by such individuals will cease to be excluded property for IHT purposes during the period the settlor is UK resident.

The Government is introducing a grace period to allow such individuals to return to the UK occasionally for short periods. The rule will apply for IHT only and will mean that such individuals will not be treated as UK domiciled unless they were resident for at least one of the two tax years prior to the tax year in question. The grace period will also apply to settlors of offshore trusts.

HOW CAN BDO HELP?

Understanding the date an individual becomes deemed domiciled will be key to their tax position and BDO can assist with a residency review. In addition, for non-doms returning to the UK after a period of residence abroad, BDO can advise on the ramifications of doing so. Failure to take into account these changes can lead to a greatly increased tax liability.

OPPORTUNITY TO UPLIFT ASSET BASE COSTS

Pre-6 April 2017 gains will not be taxed on deemed UK domiciled individuals in some circumstances.

CAPITAL GAINS TAX – REBASING OF OFFSHORE ASSETS

Where an individual becomes deemed UK domiciled, subsequent capital gains made on the disposal of assets (whether UK or offshore) would automatically trigger a capital gains tax charge in the UK. However, for individuals who become deemed domiciled on 6 April 2017 (and no later) and who were not born in the UK with a UK domicile of origin (formerly domiciled resident), the Government has confirmed that the proportion of any non-UK gain that accrued prior to 6 April 2017 will not be taxable. This would also allow that proportion of gain to be brought to the UK with no further tax charge if properly segregated.

To achieve this, assets held personally outside the UK will be revalued for capital gains tax purposes as if they were acquired on 6 April 2017 (effectively exempting the earlier gain). However, despite lobbying, assets held within overseas structures such as trusts or companies will not benefit from the uplift. It is understood, however, that partnership assets and certain offshore investment funds will also qualify for rebasing.

Where the rebased assets were originally acquired with unremitted overseas income or gains there would still be tax on a remittance of proceeds in excess of the rebased non-taxable gain (ie the original cost of the asset if acquired with foreign income or gains). However, it may be possible to separate the proceeds (once received into an offshore bank account into their constituent parts using the cleansing ability discussed in the next section so allowing access to the rebased gain element.

There are a number of conditions for rebasing to apply including the requirement that the asset must not have been situated in the UK at any time between 16 March 2016 and 5 April 2017. A further condition is that the individual must have paid the remittance basis charge (which was introduced from 6 April 2008) in any year before April 2017 and be deemed domiciled throughout the period from 6 April 2017 to disposal. The individual must also be UK resident as at or 'on' 6 April 2017. An irrevocable election can be made to dis-apply rebasing on an asset by asset basis. This may be worth considering, for example, where assets are standing at a loss as compared to the purchase price.

The Government has also confirmed that from 6 April 2017, capital losses will be available to offset against capital gains for deemed domiciled individuals regardless of whether they previously made the offshore capital loss election. However, an irrevocable election will be required so as to gain access to such losses.

HOW CAN BDO HELP?

For individuals who will become deemed domicile in the UK from 6 April 2017, we can help you review the tax status of your offshore assets.

AN OPPORTUNITY TO TIDY UP

As part of the reforms, the Government is allowing non-doms a one off opportunity to segregate their 'mixed funds' to allow more tax-efficient remittances to be made in future.

OFFSHORE MIXED FUNDS OF INCOME AND GAINS

Unremitted income and gains that arose in years before the individual becomes deemed UK domiciled will still be taxed on the remittance basis.

Where an offshore bank account contains a mix of unremitted overseas income, gains and tax-free (clean) capital, the UK tax rules prescribe the order in which each element is deemed to be remitted, with income generally remitted first. This can make it hard for a non-dom to access their original clean capital without triggering unwanted tax charges.

As part of the reforms, the Government is introducing a temporary window of two tax years (the first proposal was only for one year) from 6 April 2017 during which individuals can rearrange their mixed funds overseas to separate them into their constituent parts (eg tax-free capital, income, gains) by moving them into separate offshore accounts. The intention is to provide certainty on how later remittances will be taxed.

Broadly, the transitional period:

- Only applies to mixed funds consisting of amounts deposited in bank and similar accounts
- Will not apply to individuals born in the UK with a UK domicile of origin
- Can be claimed by any non-dom individuals who were subject to the remittance basis between 2008/09 and 2017/18 (even if they are not UK resident at April 2017).

The idea is that once the funds have been separated, the owner will be able to bring 'clean' capital into the UK without suffering a tax charge. If historic income and gains are remitted at a later date, they will be taxed at the appropriate rates for the year in which they are remitted.

Non-doms with mixed funds may, therefore, wish to separate them into their constituent parts once the new rules are in force to make future remittance planning easier. The legislation is prescriptive on how this will be achieved. Where mixed funds have been invested in other assets there may be further issues to consider.

Combining this segregation technique with rebasing for deemed domiciled individuals will not only tidy accounts up but may be used to generate amounts of clean capital for UK expenditure requirements.

HOW CAN BDO HELP?

Identifying different elements of mixed funds that have built up over many years can be a complex task but BDO's expert team can carry out an analysis of your financial records to identify the composition of your mixed funds and substantiate the clean capital available to you.

There are clear advantages in starting this process early, so please contact us as soon as possible if you wish to resolve a mixed funds issue.

We would work closely with your bankers not only in identifying the various components but also to suggest a tax-efficient and manageable banking structure going forward.

OFFSHORE TRUST REFORMS
Significant changes

TRUST REFORMS

As previously announced, certain tax protections will be maintained for offshore trusts provided they were set up before the individual became deemed UK domiciled under the 15/20 rule.

Gains and foreign income arising within a trust structure set up by a non-UK domiciled settlor before they were deemed UK domiciled, will not be assessed on the settlor as they arise provided no property has been added to the trust (otherwise than at arm's length and with certain exceptions) and the settlor is neither UK domiciled under general law nor a formerly domiciled resident. Instead, such foreign income and gains will only be taxable when matched to a benefit received. The broad principle will be that income will be matched ahead of capital gains.

The tax charge will be on a non-UK domiciled or deemed UK domiciled settlor to the extent that benefits are received by them or members of their close family (which includes spouse/co-habitee/minor children) and where the benefit is not otherwise subject to tax on the recipient. The treatment of non-UK income arising in such structures before 6 April 2017 is yet to be clarified.

The settlor's close family may be taxable on capital payments received from the trust but if they can still qualify for the remittance basis (and do not remit) then the deemed domiciled settlor will be taxed instead. A non deemed domiciled settlor may still be able to claim the remittance basis to protect such gains. There will be a right of recourse by the settlor to the trustees upon the provision of a certificate of tax paid by HMRC.

UK income of offshore trusts or their underlying entities will be taxed on the settlor in the same way as it is now.

From 6 April 2017, any payments made to a non-resident beneficiary will not reduce the available capital gains tax pool for matching purposes.

Rules are also being introduced to tax the settlor on payments being made to a non-close family member who makes gifts to the settlor within three years (NB this period is unlimited if the steps are considered to be preordained).

It is vital to note that if the trust is tainted (either by way of addition of new property after becoming deemed domiciled or if the trust is split or re-settled) then the current anti-avoidance rules for UK resident and domiciled settlors of offshore trusts will apply. It is understood that interest free loans to trusts will be considered to taint the trust and therefore should be reviewed urgently. Broadly, if this applies, all income and trust gains from that point onwards will be treated as if they were received by the settlor and taxable on him as they arise.

Other parts of the reforms deal with the valuing of certain benefits. For art work, it is proposed that the value of the benefit is calculated at the HMRC official rate (currently 3%) of the acquisition cost less costs borne by the beneficiary such as insurance.

For loans made to beneficiaries, the benefit will be interest calculated at the official rate less interest actually paid in the tax year. This would have an effect on loans where interest is rolled up.

It is clear that trust settlors and their families will need to review their current arrangements with the trustees and their advisers as soon as possible. We recommend that expert advice is taken as the interaction between the trust tax changes and the other reforms will inevitably mean that a full review is needed.

However, in the right circumstances, trusts will offer valuable protections going forward and, given that the Government has given its blessing to such structures, they should be considered a key part of any non-dom's planning.

HOW CAN BDO HELP?

BDO has a great depth of experience in advising clients around offshore trusts and has a very good reputation among trustees in a number of jurisdictions.

As well as advising on tax consequences for the settlor or beneficiary, BDO can also advise the trustees of their own reporting and filing obligations.

UK RESIDENTIAL PROPERTY

More homes will fall within the UK IHT net from 6 April 2017 onwards

IHT ON UK RESIDENTIAL PROPERTY

The Government has confirmed that it intends to extend the charge to UK IHT on UK residential property held indirectly by non-doms through an offshore entity (eg a company, overseas partnership or a trust). The new rules will apply both to non-dom individual shareholders or partners and to trusts with non-dom settlors and apply to all chargeable events (eg a death or a trust 10 year anniversary) after 5 April 2017.

Under the current rules, UK property owned by an offshore company or partnership can fall outside an IHT charge and be treated as ‘excluded property’ where either the owner of the entity is not UK domiciled or, if deemed domiciled for IHT purposes, is owned by a trust which was set up before the settlor was deemed UK domiciled.

Making a technical change to the definition of offshore excluded property will mean that the shares in such offshore companies (broadly those controlled by five or fewer shareholders) or partnership interest will fall within the UK estate of non-doms from 6 April 2017 onwards to the extent that the company (or partnership) derives its value from UK residential property. Any qualifying interest in a close company or partnership will be ignored where its value is less than 1% of the total rights or interests in that company or partnership. This will affect both UK resident non-doms and non-resident non-doms.

Debts secured on the property will be deductible from the value charged to IHT as will connected party loans used to acquire the property. There would be a restriction on the amount deductible where the company or partnership has other assets.

However, such a loan would then be treated as a UK relevant loan for the creditor for IHT purposes, potentially bringing other persons within the scope of IHT who previously were not.

This will apply, for instance, to loans made by Trustees to help beneficiaries acquire UK residential property (including structures already in place).

Responsibility for paying the IHT will fall on the executor, trustees or beneficiaries of the deceased although the Government will reconsider its previous thoughts to enforce collection through directors where an offshore company owns the property.

The Government will also bring in a targeted anti-avoidance rule to disregard any arrangements whose whole or main purpose is to avoid or mitigate an IHT charge on residential property.

A further change will apply to certain Double Taxation Agreements (such as with India and Pakistan) which will allow HMRC to make a charge in circumstances where the current rate of IHT in the other country is zero or where there is no equivalent tax regime.

Some other changes confirm that the definition of a UK residential property should follow the current rules for non-resident capital gains tax as opposed to the more limited definition which is used for the purposes of the annual tax on enveloped dwellings (ATED). This will ensure that all UK residential properties, including investment properties, will be caught.

Complications can arise where the property has been subject to a change in use (eg from commercial to residential) and the Government has decided to apply the actual status of the property at the time of the relevant chargeable event rather than a hybrid formula.

The rules will also introduce a deeming period; eg where a property is sold after 5 April 2017, the proceeds will be considered to be deemed as UK residential property for the following two years (even if they are reinvested into another asset). In addition, where property is gifted (eg through giving away company shares), these events would fall within the normal rules for IHT such as the need to survive for seven years from the date of transfer.

While these rules may lead some individuals to unwind structures owning UK residential property, this can give rise to unexpected tax charges and the Government has reiterated that it will not provide any incentive to encourage ‘de-enveloping’ of UK properties (ie removing them from offshore structures).

HOW CAN BDO HELP?

Overall, this is a major change for non-doms and it will be more difficult to manage IHT exposure on UK residential property.

Affected non-doms should review existing arrangements, including comparing the merits of maintaining existing structures and paying the ongoing ATED charge against unwinding and paying any one-off taxes at that point.

BDO can assist with these calculations and advise on potential restructuring.

It will also be important to review any connected party funding to take into account the potential for IHT on other parties.

BUSINESS INVESTMENT RELIEF

Becoming more accessible

Business Investment Relief (BIR) was introduced in 2012 to allow non-doms to bring their foreign income and gains to the UK for investment into UK businesses without triggering a remittance tax charge. While the take up has been reasonable (around £1.5bn has been invested), the Government believes more would be invested if the rules are improved.

Currently, there is a highly restrictive exemption where non-doms bring funds into the UK to invest in UK business and there are considerable downsides if any of the conditions are breached since that could then turn the investment into a taxable remittance.

Following the latest consultation, the Government has confirmed that it wants to make the current rules more attractive for non-dom investors. It has confirmed a number of changes including:

- The relaxations of some of the 'extraction of value' anti-avoidance rules to disregard transactions from so-called 'involved companies'. Broadly, this means that the anti-avoidance rules should only apply to the actual company or group in which the investment has been made
- The extension of the grace period where a breach has occurred to two years to allow appropriate mitigation steps (eg to take funds back offshore)
- The time period for a business to commence trading will be extended to five years instead of the existing two to recognise longer lead times in certain projects; eg infrastructure type projects - a welcome development
- The ability to buy existing shares from another shareholder rather than having to subscribe for new shares in the company
- The creation of a 'hybrid' company category for qualification purposes where the company is both trading and a stakeholder company in other trading companies.

While the Government has improved the position, there is more to do to make the relief attractive to investors and they have committed to consider additional relaxations at a suitable future fiscal event.

One issue it has confirmed, however, is that investments made through partnerships will still not qualify for the relief - which is disappointing.

HOW CAN BDO HELP?

BDO have advised on a number of qualifying investments and have helped to obtain advance clearances from HMRC in less than straightforward situations.

Please get in touch with your usual BDO adviser or contact one of our private client team **(Refer to page 12 of this document)** if you require assistance with any claim.

POTENTIAL ACTION NEEDED BEFORE 6 APRIL 2017

Now is the time to take action

DEEMED DOM RULES AND OFFSHORE TRUSTS

All non-doms, whether they will become deemed domiciled on 6 April 2017 or later, should review their worldwide assets and their ongoing financial needs both in the UK and offshore.

For those who can settle an offshore trust, they may wish to consider doing so before 6 April 2017 in order to obtain the protections going forward.

For existing trusts, consideration should be given to making distributions ahead of 6 April 2017 while the opportunity remains. In addition, any loans to trusts should be reviewed urgently.

For deemed domiciled individuals who will benefit from rebasing of assets for CGT, they should consider retaining the assets until 6 April 2017. This is of course an investment decision as well.

However, the respective advantages of obtaining a CGT uplift versus achieving IHT protection with the use of a trust should be assessed on a case by case basis.

Cleansing of funds from 6 April 2017 represents a real opportunity to access previously 'locked' clean capital and, with appropriate planning, may be used in conjunction with the rebasing rules to generate an amount of clean capital.

It is clear that trust settlors and their families will also need to review their current arrangements with the trustees and their advisers as soon as possible. We recommend that expert advice is taken as the interaction between the trust tax changes and the other reforms will inevitably mean that a full review is needed.

Other more general planning should be considered before 6 April 2017 such as the making of gifts to family members, which might otherwise be potentially exempt transfers for IHT purposes, requiring a seven year survivorship period if made after 5 April 2017.

It may be prudent, if possible, to accelerate offshore dividends (subject to separate commercial and investment considerations) or bonuses for those claiming the remittance basis for the final year.

It may be that some non-doms will choose to leave the UK before 6 April 2017 and in which case urgent advice should be sought.

And lastly, particularly if action is going to be taken before 6 April 2017, non-doms need to be certain that they remain non-domiciled under general law and can point towards a definite intention to leave the UK in the future.

UK RESIDENTIAL PROPERTY

The wide ranging changes to the IHT regime mean that anyone holding UK residential property should review their existing structure urgently to see whether it is fit for purpose going forward or whether it is better to unwind the position. This should be done before the next ATED return period commencing 1 April 2017.

Connected party loans used to acquire such property also need to be reviewed urgently since the rules as drafted will bring the lender within the scope of IHT for the first time.

BUSINESS INVESTMENT RELIEF

Given some of the relaxations, BIR may be more attractive to non-doms and anyone considering investing into the UK should give proper consideration to utilising this valuable relief.

NEXT STEPS

Although in draft, the overall shape of the new regime is now much clearer. With only a short period to go before 6 April 2017, non-doms should seek specific advice on what impact these reforms will have on their UK tax liabilities and what remedial action may now be appropriate.

BDO is well placed to advise affected clients, having been part of the consultation period throughout and having had regular dialogue with the Government.

Clearly a number of factors will need to be considered in each case and separate legal/and or investment advice may also be required.

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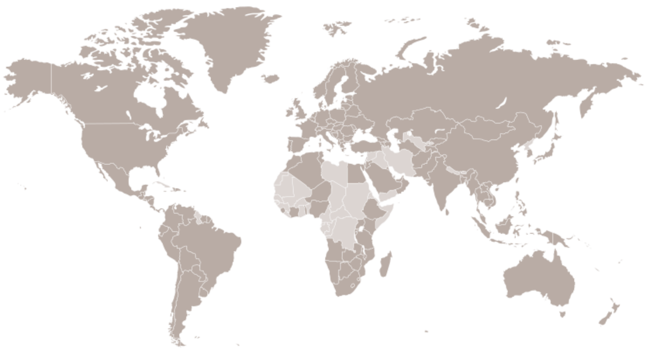

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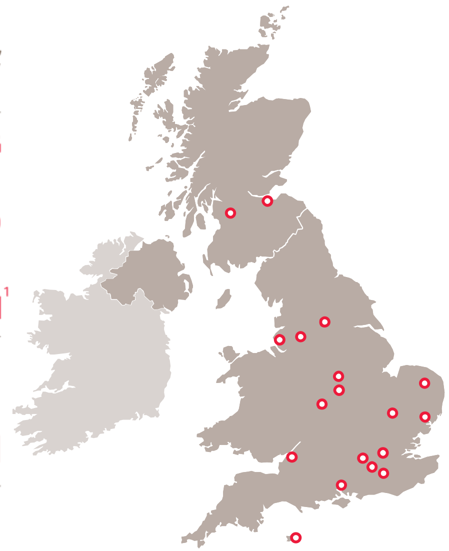
1. Independent research (Mid Market Monitor 2013-2016) undertaken by Meridian West shows that BDO, for the third year running, have the highest proportion of clients who would recommend their advisers among its peer group



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