



Second consultation on reforms to taxation of UK resident non-domiciled persons

Nerine Trust Company Limited 23 August 2016

Background

On Friday 19th August, 2016, the government released its second consultation on reforms originally announced in the Summer Budget of 2015.

The key policy objective of the reforms is to bring an end to permanent non-domiciled status for UK resident taxpayers (**Non-Doms**) and to prevent the use of offshore companies to avoid inheritance tax (**IHT**) on ownership of UK residential property (**UK RP**).

Despite the unexpected Brexit vote and the changes in numbers 10 and 11 Downing Street, the reforms are going to go ahead more or less as planned. The Brexit vote has had no impact on the government's assessment of the balance between fairness and international competitiveness of the proposed reforms.

IHT on UK RP

The 2015 budget proposed that from 6th April 2017, it would no longer be possible to avoid IHT on UK RP by holding it through an offshore company. There will be an IHT implication for shares in such companies for individuals and trustees, and the reform will apply to existing structures.

In terms of valuation for IHT purposes, this is the value of the shares to the extent that the value of those shares relates to a UK RP.

Using the example given in the consultation:

- The sole asset of an offshore company is a residential property worth £1 million
- The market value of the shares in the company is £950,000
- So the value for IHT purposes is £950,000.

Clearly, where the company holds assets other than UK RP, the calculation will be somewhat more complicated.

Debts which are related to the UK RP, can be offset against the value, but loans between "connected parties" will be disregarded for valuation purposes.

As always, the government is concerned about avoidance schemes, so it will introduce a Targeted Anti-Avoidance Rule.

In terms of liability and accountability for paying the tax, this will be extended not only to trustees, but also to any legal owners of property, including company directors.

There will be no transitional arrangements in relation to this charge and no incentives to "de-envelope" will be offered.

Deemed UK domicile for long-term residents

It is proposed that from 6th April 2017, an individual will become deemed domiciled for all tax purposes if they meet one of two conditions:

- Condition A – They were born in the UK and have a UK domicile of origin, have acquired a domicile of choice abroad, but have resumed UK residence.
- Condition B - They have a non-UK domicile of origin and have been resident in the UK for 15 of the past 20 tax years.

The first consultation in September 2015 considered a number of questions which have now been responded to:

- The statutory residence test will not be used to test residence in any and all of the relevant tax years. The question of whether an individual was resident in any given tax year will be determined under the law that applied at that time.

- Years spent in the UK during childhood will count in the 15/20 calculation.
- Even if you were resident in the UK for a single day in any given tax year, under the applicable test, that will count as one of your 15 years.
- Where an individual realised a gain whilst non-resident prior to the 2015 budget announcements, the reforms will not apply to that gain.
- If an individual left the UK prior to being deemed domiciled under the old 17/20 rule, but then returns to the UK, the 15/20 rule will still be applied.
- However, where a Non-Dom makes a potentially exempt transfer (PET) of a non-UK situs asset whilst having a Non-Dom status, and dies having become deemed domiciled under the new rules, the PET will be excluded.
- Rebasing will be available, but only for individuals who are deemed domiciled as a result of the reforms coming into force on 6th April 2017. These individuals will be entitled to rebase the value of foreign situs assets as at 5th April 2017. This relief will not be available to individuals who satisfy Condition A.

For non-resident trusts:

- The government has decided not to introduce a flat rate charge for distributions out of trusts.
- For existing trusts, settlors will not be charged CGT on trust gains on an arising basis when the settlor becomes deemed domiciled unless the settlor, their spouse or minor children receive a benefit from the trust. In this event, it appears that the protection falls away entirely, leaving the settlor liable to tax on all trust gains on an arising basis.
- There is also a protection against income tax being charged on foreign income on an arising basis. If there is a distribution to the settlor, their spouse, minor children or “other relevant persons”, this will be matched to foreign income and taxed, but the protection will not be lost altogether.
- UK source income and gains will remain, of course, taxable.
- A critical point from the latest consultation is that the protections noted above will be forfeited if there are any additions to a settlement from 6th April 2017, thereby bringing in a new tainting risk. Once tainted, a trust will remain tainted even if the settlor becomes non-domiciled again subsequently, so if/when the settlor returns to the UK and reacquires UK domiciled status, the protections afforded by the legislation will not be available.
- The government will keep the current £2,000 de minimis protection that allows Non-Doms to remit foreign income and gains without paying tax, or having to include them on their tax return. Once they have become deemed domiciled, they will be able to offset their UK allowances (including the new dividend allowance announced) against foreign and UK income and gains.
- Foreign losses will be available to offset against gains, but only after the individual becomes deemed domiciled.
- Whilst an individual will have to be non-resident for 6 years in order to lose their UK deemed domiciled status for income tax and capital gains tax, the current four-year period for IHT will remain.

Individuals born in the UK with a UK domicile of origin

The government have refused to deviate from their original proposals, so an individual who satisfies Condition A as noted above will become deemed domiciled after they resume UK residence.

However, the government has agreed that there will be a grace period, but for IHT only.

If the returning UK individual is resident in the UK in any tax year, the deemed domiciled provisions will only apply for IHT if the individual was resident during at least one of the two previous tax years.

This concession is not going to be available for income tax or CGT, so the remittance basis will not be available for the returning Condition A expat.

The government conclude that there will be no other revisions to the proposed legislation, other than those contemplated in this second consultation paper.

Business Investment Relief (BIR)

The government note that over £1.5 billion has been invested in the UK under the BIR scheme, and they are keen to hear from industry as to how Non-Doms might be encouraged to increase their investment through the scheme even further.

This might seem incongruous given the above, but an individual who may be about to become deemed domiciled in the UK may see this as a valuable opportunity to invest in qualifying businesses using untaxed foreign gains.

Conclusions for Nerine and its clients

- For clients who have not yet settled a trust and who are either close to or over the 15/20 mark in terms of residence, but not yet at the 17/20 mark, there seems to be a substantial incentive to establish a trust before the new deemed domiciled regime comes into force next April.
- Thereafter, the timeframe for establishing a trust for a long-term UK resident Non-Doms is going to be shorter than before, given the 15/20 rule, and the timeframe for losing Non-Dom status for income tax and CGT is extended to 6 years.
- It is a positive that the four-year IHT period has survived.
- It is equally positive that there are protections for settlor's from the deemed domiciled provisions from having to pay tax on an arising basis on foreign income and gains.
- However, these protections are fragile, in that they can easily be lost either completely or temporarily if funds are distributed or added after 5th April 2017.
- For settlors of existing excluded property trusts who are likely to be affected by the 15/20 provisions, opportunities may exist for rebasing assets or restructuring completely.