NEWS

April Showers

Mark Biddlecombe, In-House Counsel at Nerine, looks at UK changes related to non-domiciled individuals, and some of the possibilities and issues these changes pose

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On 6 April 2017, life is going to change radically for long-term non-domiciled individuals (non-doms) in the UK and their advisors. Despite the long lead-up to the changes coming into force in April, much of the detail has only recently been published. There are many challenges, but also opportunities for trustees and advisors to provide significant value to their clients.

From 6 April 2017, a non-dom who has been resident in the UK for 15 of the previous 20 tax years will be deemed to be UK domiciled for tax purposes, heralding a significantly greater exposure to tax on the value of their estate, and their worldwide income and gains.

Until they become deemed domiciled, they will retain the ability to create trusts that will provide a long-term shelter from inheritance tax (IHT) for most of their estate, as well as deferral, in many cases, of tax on foreign income and capital gains tax (CGT).

Excluded property trusts

For individuals who have yet to reach the ‘15 out of 20 years’ threshold for residency, the opportunity to create an excluded property trust (EPT) will, of course, remain – with one exception. If an individual was born in the UK with a UK domicile of origin, they cannot benefit from EPT status at any time while they are UK resident.

For income tax and CGT purposes, such trusts will be known as ‘protected trusts’, but those protections are fragile, and trustees will need to be careful. Protected trusts are also still exposed to CGT on UK residential property under non-resident CGT rules. There are also some significant changes to the treatment of trust gains that will affect all trusts.

Segregation of mixed funds

A significant benefit in the draft legislation is the ability for non-doms to segregate so-called ‘mixed funds’ (capital, capital gains and income held in their own names in offshore bank accounts), as long as the elements are clearly identifiable. This facility will fall away on 5 April 2019.

Again, individuals who were born in the UK with a UK domicile of origin are penalised, as they are not able to participate.

Rebasing opportunity

There is a generous, if somewhat limited, rebasing opportunity included in the new provisions. Any individual becoming deemed domiciled on 6 April 2017 will have a one-off rebasing opportunity for any assets they hold in their personal names. There are two caveats: they must not have been born in the UK with a UK domicile of origin, and they must have paid the remittance basis charge at some point before 6 April 2017.

The ability for individuals to create a significant pool of capital will give them substantial planning opportunities, including the use of EPTs.

Resetting the clock

Individuals who have missed the opportunity to establish a trust before they become deemed domiciled will be able to reset the clock on their status by leaving the UK for four complete tax years for IHT purposes, and six tax years for income tax and CGT purposes. Given how internationally mobile and diversified non-doms are, this could be an attractive option. In the meantime, trustees, advisors and clients need to take immediate action to take advantage of the planning opportunities available.

Existing trust structures

The changes achieve the political and fiscal objective of curtailing the benefits of non-dom status; to an extent, existing trust structures are insulated, but not without hazard. The protections are attractive, but there are severe consequences to getting it wrong.

If you were born in the UK with a UK domicile of origin, the regime does not apply while you are resident in the UK. Otherwise, tax on gains or foreign income accruing within a trust is sheltered for as long as the trust remains 'protected'. This is where the trouble lies – if any property or income is added to the trust after 5 April 2017 and after the settlor becomes deemed domiciled, the trust is tainted and its protected status falls away. Once a trust has been tainted, it remains so, and the tax consequences will persist for as long as the settlor remains alive and/or UK resident.

Any property or income provided to the trust will taint it unless it is provided:

- on commercial or market-value terms – often described as an 'arm's length' transaction;
- in pursuance of any liability incurred by any person prior to 6 April 2017; or
- to meet trust expenses where there is a shortfall in the trust's income. This is a very strict rule, and if one penny more than the shortfall is contributed, the trust will be tainted.

The second of these exclusions is causing some uncertainty, particularly in respect of interest-free loans provided to a trust. There is a view that these loans will have to be called and/or repaid to avoid tainting. That is clearly one for advisors to grapple with – and fast.

A controversial additional tainting provision applies for CGT whenever a settlor or close relative (i.e. their spouse, civil partner/de facto partner, or any minor child) receives a benefit. This has the effect of making the trust what some advisors have called a 'locked box'; any benefit provided to the settlor or a close relative taints the trust, triggering a CGT exposure for the settlor on an arising basis.

For income tax purposes, there is no equivalent; the settlor will only be taxed if income is distributed to them or a close relative. However, the settlor can avoid this tax by becoming non-resident for six years.

One small positive is that there are no tainting provisions in relation to the IHT protection afforded to an EPT.

A controversial – and perhaps inadvertent – change is found in s87D of the draft legislation, the effect of which appears to be to bring back into account trust gains, which had previously been regarded as washed out to non-domiciled beneficiaries.

Any capital payments to non-resident beneficiaries will be ignored when matching gains that arise after 6 April 2017. Whether this provision is draconian or just a mistake is unclear. If it is not a mistake, then restructuring may be needed prior to 6 April 2017.

Mitigation strategies

There will clearly be structures where it is appropriate to extract assets from structures before the new rules come into place. An obvious example is trusts that involve beneficiaries occupying UK residential property other than on commercial terms. Given that such property will no longer provide any IHT protection after 5 April 2017, it is hard to find a rationale for holding such assets in the trust where the settlor is UK deemed domiciled, or likely to become so.

There may well be strong arguments for creating multiple trust structures out of the existing trust before 6 April 2017. This may allow clear segregation of capital, capital gains, income, etc.

Trustees need to develop an urgent list of things to do in the little time left for some resident non-doms. Where there is a UK-resident settlor and/or beneficiaries, all details of the structures and the actors need to be forensically reviewed.