Non-Dom changes following the publication of the 2017 Finance Bill

March 2017

Introduction

This note provides a summary of the changes to the rules in connection with the taxation of non-UK domiciled individuals ("non-doms") as they currently stand. This note is not exhaustive, and we strongly recommend that you seek tailored professional tax advice if you are affected by these measures.

The Finance Bill published on Monday 20 March 2017, included the latest iteration of legislation in respect of changes to the taxation of non-doms that will come into effect from 6 April 2017.

Some provisions included in previous drafts were not included in this latest version and the Government have confirmed that these will be deferred to a later Finance Bill.

Whilst many areas of uncertainty have been clarified, the legislation still lacks clarity in a number areas. We will continue to make representations on the difficulties this causes and we have requested comprehensive guidance notes on the application of the new clauses. However, no further guidance or updates to the legislation are expected before it comes into effect on 6 April 2017.

Residential Property

Closely held offshore structures holding UK residential property will be brought within the charge to UK IHT. Loans provided by individuals, trusts, closely held companies or partnerships for the acquisition, maintenance or enhancement of UK residential property will also be brought within the charge to IHT in the hands of the lender.

IHT for individuals and trustees

IHT is charged on the death of an individual at 40%. It also applies in respect of certain lifetime gifts at a rate of 20%. For trustees, IHT is charged on every ten year anniversary of the trust's creation at a rate of up to 6%. IHT may also be charged where capital distributions are made by the trustees. Where a settlor can benefit from property in a trust, both the 40% charge on death and the 10 year / exit charges will apply.

The legislation sets out that the following will no longer be 'excluded property' for IHT purposes (i.e. will be specifically within the charge to UK IHT):

1. A right or interest of more than 5% in a non-UK closely held company or partnership, the value of which is directly or indirectly attributable to UK residential property. A right or interest for these purposes could also derive from a shareholding or a loan creditor relationship.

2. Loans made to acquire, maintain or enhance a UK residential property. This means that loans which would otherwise be considered to be non-UK situs assets could be brought within the charge to UK IHT for the lender.

For example, where a loan has been made by a non-UK resident trust to a non-UK resident individual to enable the individual to purchase UK property, the trustees will be subject to UK IHT in relation to the value of the loan. The individual will also be subject to UK IHT in relation to the net value of their interest in the UK residential property.

3. Funds held or otherwise made available as security, collateral or guarantee in relation to a loan for the acquisition, maintenance or enhancement of a UK residential property. The amount within the charge to IHT is capped at the value of the relevant loan.

4. Funds realised on the sale of the UK residential property that are held offshore can immediately become excluded property and would then no longer be within the charge to IHT. Funds

realised as the result of the disposal of an interest in a close company or partnership that owns UK residential property will, however, remain within the charge to IHT for the next 2 years, creating a 'tail', following the realisation. The proceeds received on the repayment of some loans (in connection with UK residential property) are also within this 2 year rule.

Targeted anti-avoidance measures have been put in place in relation to the above to counteract any structuring or restructuring that is considered contrary to the intentions of this legislation.

Where current double taxation agreements would give taxing rights in relation to non-UK situs assets to the country of a person's domicile rather than residence, the draft legislation indicates that this will only be effective if IHT will actually be applied in the country of domicile. If tax is not applied, or applied but at a rate of 0%, then UK IHT will still apply, as set out above. This may be of particular relevance to individuals domiciled in India and Pakistan.

Deemed domicile and long term residents

From 5 April 2017, non-doms who have been UK resident for 15 out of the previous 20 tax years will be treated as deemed domiciled in the UK for all tax purposes.

Individuals will no longer be deemed domiciled for income and capital gains tax purposes if they retain their non-domicile status under general law and cease UK residence for six complete tax years; or for inheritance tax (IHT) purposes if they cease UK residence for four complete tax years.

Returning Non-Doms

Individuals born in the UK with a UK domicile of origin who have acquired a domicile of choice elsewhere, but who return to the UK ("returning non-doms") will have a two year grace period on resuming UK residence before their worldwide assets become subject to IHT, but they will be subject to income and capital gains tax on an arising basis as soon as they return.

Any offshore trusts set up by such individuals during their period of non-domicile will be within the scope of UK IHT. In addition, returning non-doms will not be able to benefit from asset rebasing or relief for mixed fund bank accounts, as set out below.

Trusts

Since the original announcement of the changes to the taxation of non-doms the Government has promised that there will be 'protections' in relation to offshore trusts, established by non-doms prior to becoming deemed domiciled due to being long term UK residents. Delivering on this promise has proved to be one of the most complex areas of the new legislation and there still remains significant questions over how the new legislation will work in practice.

It is worth noting that in order to provide protections for individuals becoming deemed domiciled, the Government has changed the way in which all offshore trusts are treated, not just those settled by individuals that are deemed domiciled.

In the absence of trust 'protections' a deemed domiciled settlor who retains an interest in a trust that they created would be taxed on all the income and gains of the trust on an arising basis.

The protections are designed to avoid taxing the non-UK income and gains of such a trust on an arising basis, but instead tax them only when distributed or otherwise made available to a UK resident beneficiary.

To benefit from the trust protections certain conditions must be met:

1. the trust must have been settled before the individual becomes deemed domiciled in the UK;
2. the settlor must remain not domiciled in the UK under general law;
3. the settlor must not have been born in the UK with a UK domicile of origin; and
4. neither the settlor, nor the trustees of another settlement of which the individual is a beneficiary or settlor must make any additions, directly or indirectly, to the trust once they are deemed domiciled.

Condition 4 has given rise to the 'tainting provisions' which provide helpful additional guidance on what HMRC will consider an 'addition' for these purposes.

Additions include not only cash and property, but also include some less obvious actions. For example, a non-arm's length loan to either the trust itself or a company underlying the trust will 'taint' the trust.

The legislation has detailed provisions regarding loans made to trusts and between trusts with common beneficiaries or settlors and what constitutes an addition of value.

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In order to be considered on arm's length terms, loans must:

- be repayable on demand;
- charge interest at least the official rate of interest in the case of a loan to a trust and at not more than the official rate of interest in the case of a loan from a trust; and
- the interest must be actually paid at least once a year.

In recognition of the late timing of these announcements the legislation provides a one year grace period (until 5 April 2018) in which existing loans can be reviewed and amended to prevent tainting.

The legislation does also provide for certain additions which can be ignored for tainting purposes, such as those resulting from arm's length transactions; additions relating to pre 6/4/17 liabilities; and additions to meet taxation and administration expenses where those expenses exceed the trust's income for the year.

Protected trust status

The gains and non-UK income of a protected trust will not be attributed to the settlor unless the settlor (and in some cases the spouse or minor child of the settlor) receive a distribution or benefit from the trust.

Current trust rules, which attribute the income of both the trust and its underlying companies to the settlor, have been amended to introduce the concept of 'protected foreign source income'. Protected foreign source income is not attributed to the settlor, it is added to the general pool of trust income which is available to match to distributions made to either the settlor or other beneficiaries, regardless of whether they are UK domiciled or not.

Similarly, gains arising to either the trust or its underlying companies will form a pool of gains available to match to capital payments. Capital payments are usually matched to income in priority to gains.

There are a number of points to watch out for under these new rules:

- Where a non-UK resident or remittance basis user spouse or minor child of the settlor receives a benefit from a trust, that benefit will be attributed to the settlor if UK resident and taxed accordingly.
- Pre 5/4/17 income in a trust which would have been attributable to the settlor under current rules will form part of the general pool of trust income available to match to future distributions after 6/4/17.
- Capital payments made pre 5/4/17 which are not matched to capital gains prior to 5/4/17 could be taxed on an arising basis if matched to post 6/4/17 capital gains.
- Remittances of income or gains by a trust or an underlying company, eg investing in UK assets, after 6/4/17 will not be a remittance for the settlor under the relevant person rules.

Valuing benefits received from settlements

The Finance Bill sets out how benefits provided by trusts are to be valued for tax purposes going forwards. The mechanism of calculating the value of benefits is set by formulas, based on the official interest rate.

Benefits included in the legislation are loans, the use of movable property (e.g art) or making land and property available to beneficiaries. All benefits made by trustees to beneficiaries should be reviewed in light of this new legislation.

Capital gains tax rebasing

Those individuals who will become deemed domiciled from 6 April 2017 under the 15/20 year test will be able to rebase their directly held foreign assets to their market value as at 5 April 2017.

Main points:

- The asset must have been non-UK situs from the later of 16 March 2016 or the date of acquisition until 5 April 2017.
- Individuals must have paid the remittance basis charge at some point before 2017/18 in order to qualify for rebasing.
- The individual must remain non-UK domiciled under general law up to and including the tax year in which the asset is disposed of.
- Individuals will need to elect, asset by asset, for the rebasing *not* to apply. The election is irrevocable.
- Assets which are subject to income tax on disposal, such as interests in non-reporting status offshore funds will benefit from rebasing.

Cleansing of overseas mixed fund bank accounts

Non-doms who are taxed on the remittance basis will have a two year period during which they can "tidy up" their mixed funds held in overseas bank accounts.

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This will enable them to rearrange their offshore bank accounts and separate mixed funds into their constituent parts (provided that these can be identified) – e.g. they can move their clean capital, foreign income and foreign gains into separate accounts, and then remit from those accounts as they wish.

Such cleansing is available to any non-dom to whom the remittance basis applied before 2017/18 other than "formerly domiciled residents" – i.e. it is not restricted to those becoming deemed domiciled in April 2017 under the 15/20 year rule, unlike rebasing.

Main points:

- The opportunity to cleanse mixed funds is only available in 2017/18 and 2018/19.
- Cleansing is only available to amounts held in bank accounts, not to other assets.
- The transfer from a mixed fund to a new account must be nominated for this purpose and there can be only one transfer from each mixed fund to that particular new account.
  - HMRC have confirmed since the last draft of the legislation published in January, that pre 2008 mixed funds would be able to benefit from the cleansing rules. However, there is nothing in the Finance Bill that states this. We understand extending the cleansing of mixed funds to earlier years is to be affected by government amendment .

Anti-avoidance measures not included in the final 2017 Finance Bill

Some of the provisions not included in the final 2017 Finance Bill but included in previous drafts, have been delayed for a future Finance Bill. Such provisions include:

- Capital payments to non-residents being disregarded when considering the pool of gains within an offshore trust available to be matched to capital payments made to UK resident beneficiaries.
- The recycling rule. Previous versions of the legislation contained provisions for taxing the ultimate recipient of onward gifts of income and capital distributions from trusts by beneficiaries, within three years. However existing anti-avoidance legislation is still applicable in such circumstances if an onward transfer/gift is anticipated at the time of a distribution from a trust.
- Provisions attributing benefits and payments made to close family members to a UK resident and deemed domiciled settlor are not in the Finance Bill.

We can work with you to assess the wider implications of the new measures for your existing position, and the merits or otherwise of making changes. We can also advise you on the tax and legal implications of any changes you want to make and assist you in implementing them. To discuss this further, you can call your usual PwC contact.

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