BLICK ROTHENBERG

Webinar: Changes to the taxation of non-domiciled individuals
9 December 2016

On Monday we finally received the publication of the draft Finance Bill, together with a consultation response, on the proposed changes to the taxation of non-UK domiciliaries. On the basis that much of the Finance Bill and the Consultation confirm that the rules will operate as previously announced I intend to focus this morning only on those aspects which are in addition to or are different from those which have been previously announced. I therefore am assuming that those listening will have a high level of knowledge and I do apologise if some of it becomes quite technical.

Unfortunately, even though some draft legislation was published on Monday, there will be a further wait, possibly until March next year, until all of the legislation becomes available. My comments today are therefore based on what has been released and what the consultation response has confirmed is still to come.

We already know that the 15/20 rule will be introduced, that there will be an opportunity for those becoming deemed domiciled on 6 April to rebase offshore assets and that there will be a form of relief to untangle mixed funds.

However, we now at last have a little more detail on what the taxation of offshore trusts will look like and also more detail around rebasing and how the rules impacting residential property held by offshore structures will be introduced.

You can see on the agenda the areas I will be talking about. So without further ado I am going to jump in and highlight the additional information we now have available.

The rebasing rules that were previously announced remain largely unchanged. The latest consultation has confirmed that rebasing is only available to individuals who become deemed domiciled on 6 April 2017 and providing they have paid the remittance basis charge at some point since 2008. This news will have been disappointing for those who are approaching the 15/20 deemed domiciled position with effect from 2018 or subsequent years. The rationale for this appears to be that those individuals have a longer time period in which to plan and rearrange their assets.

Confirmation was also provided that had been expected – that rebasing is not available for assets held in trusts or assets held through offshore companies.

It was also disappointing to get specific confirmation that rebasing will not be available where gains arising on a disposal are subject to income rather than capital gains tax. The most common example of when these rules will apply is on the disposal of an interest in a non-UK fund which does not have reporting status.

The legislation provides that rebasing applies automatically to disposals of all personally held non-UK assets owned on 5 April 2017 as long as the asset has not been a UK situated asset at any time since 16 March 2016 or, if later, the date the asset was acquired. If it is not beneficial for the asset to be rebased because it is standing at a loss at April 2017 then the tax payer can elect for the rebasing not to apply to that specific asset.

Overall the rebasing rules remain quite generous in that the increase in value of an asset standing at a gain can subsequently be remitted to the UK without tax. However, it is disappointing that the rebasing has not been extended to offshore non-reporting funds. Where individuals own interests in such funds they should look to manually rebase those assets so that the gain inherent in the asset today is uplifted whilst the remittance basis can be claimed. If this exercise is undertaken then only the subsequent increase in value would be subject to UK tax on the arising basis.

Overall the changes proposed in relation to cleansing or untangling mixed funds have remained the same as previously outlined. However, the government have helpfully extended the opportunity to cleanse the mixed funds by an additional year. So now it will be possible to untangle mixed funds during the period from 6 April 2017 to the 5 April 2019.

It was also confirmed that the untangling relief only applies to cash and not other assets held offshore.

While the relief sounds incredibly generous it will come at a cost as non-doms will have to compute the source of funds in a mixed account in order to be able to identify what can be remitted to the UK tax efficiently. It is still not clear whether every single pound in the account has to be identified or, as I hope, whether it should be possible just to prove what is clean capital, without computing all income and gains, transfer the capital to a new account and then bring that to the UK. This would seem to be a practical way of dealing with the computational challenges that would otherwise arise, but it would be helpful to have confirmation from the Revenue themselves that this treatment will be acceptable to them.

Rather than spending a lot of time looking at what the rules for offshore trusts currently are, or what they were originally proposed to be, I intend just to focus on the rules which have now been confirmed.

Overall there has been a significant improvement to the rules for offshore trusts where the settlor has become deemed domiciled for all tax purposes. Unfortunately, whilst we do have draft legislation in relation to the capital gains tax position, the Treasury draughtsmen seem to have run out of time and currently there is no draft legislation available in relation to the income tax rules. Therefore my comments are based on a mixture of the legislation that is available and the comments in the consultation response document.

So, to start with the good news!

Where a settlor has established a trust prior to becoming deemed domiciled in the UK, gains and non UK source income will not be taxed on either the trustees or the deemed domiciled settlor when they are received by the trust. However, the settlor will be taxed on any distributions or benefits that he receives from the offshore trust (depending on the level of income or gains within the structure).

Further it seems likely that the provisions which deem income arising within offshore trusts to belong to the settlor will no longer apply. If this is indeed the case it means that foreign income will be able to be used by the trustees in the UK without triggering an income tax charge for the settlor. Currently offshore trustees spend vast amounts of time segregating and monitoring the location of foreign income within structures to try and ensure none is inadvertently remitted to the UK. It would therefore be hugely beneficial if this were indeed to be the case.

However, I am afraid that there is also a fair amount of bad news.

As anticipated a deemed domiciled settlor will continue to be taxed on all the UK source income received by an offshore structure settled by him. Further, there is an additional raft of new anti-avoidance legislation.

The finance bill introduces the concept of taxing the settlor on distributions or benefits provided by the trust to the close family members of the settlor. Close Family member in this context means a spouse, civil partner, cohabitee or minor child. However, the settlor will only suffer tax where the recipient close family member is not themselves liable to tax on the benefit - i.e. where they are non-resident or non-domiciled and claiming the benefit of the remittance basis. Where this new rule results in tax being charged to the settlor then he will be entitled to reclaim the tax paid from whomever has received the capital payment or the trustee of the trust from which the payment was made.

There have also been detailed anti-avoidance rules introduced in order to prevent capital payments being made tax-free to non-UK residents or non-UK domiciliaries claiming the remittance basis which are then being passed back to UK residents by way of onwards gifts.

These “recycling rules” apply where a capital payment is made to a non-taxable beneficiary and within three years that beneficiary makes an onward gift, directly or indirectly, to the UK resident individual. Gifts made in anticipation of the capital payment (ie in the knowledge that the donor will be refunded the cost of a gift by the trust at a later date) will also be caught.

This seeks to catch a chain of gifts where both the original distribution from the trust and the onward gift to the UK resident individual occur within three years of each other. However, it should be noted that there is an indefinite extension to the three-year rule where there are arrangements in place for the UK resident to receive the sum directly or indirectly from the original beneficiary. Therefore if distributions are made from the trust with the long term intention that they will be onward gifted, the eventual UK recipient will be subject to tax even if the onward gift takes place more than 3 years after the distribution from the trust.

It is really important to be aware that the onward gift rules apply to any onward payments made on or after 6 April 2017 even if the original payment from the trust is made before that date. Therefore if such onward gifts are being contemplated they should be completed before 6 April next year.

One further popular planning technique has also been legislated against and it will now no longer be possible to wash out capital gains from offshore trusts by making payments to non-UK residents. This will be the case even where capital payments are made prior to 6 April 2017 and not matched until after April 2017.

It is important to be aware that the beneficial provisions relating to settlors who become deemed domiciled in the UK can be lost if either property or income is added to the settlement either by the settlor or by the trustees of any other trust of which the settlor is the settlor or beneficiary in a tax year on after 6 April 2017 at a time when the settlor is deemed to be domiciled in the UK.

In particular it will be important to review structures where the same settlor has created more than one trust and there are currently loans outstanding between the two trusts or their underlying companies. It appears that such arrangements, if left in place after 6 April, could effectively taint the recipient trust so that the beneficial treatment is lost.

If the trust is so tainted then the deemed domiciled settlor becomes taxable on the income and gains realised by the trust on the arising basis for as long as he is resident in the UK.

As already mentioned it is going to be essential to review all loan arrangements within offshore trusts. Without the detail of the income tax legislation yet available it is difficult to be definitive in relation to the treatment of loans but it does seem clear that loans can result in the tainting of structures.

A further issue also arises in relation to any loans deemed domiciled settlors may have made to their offshore trusts. As well as running the risk of tainting the structure by leaving the loans outstanding any repayment of such loans is likely to be matched with any income received at trust level with the consequence that it will be assessable on the settlor when the loan is repaid.

Under current rules it has been quite popular to access funds in a trust through the provision of an interest-free loan or in some cases a loan which is interest-bearing but where the interest is rolled up until final repayment of that loan. Under new rules to be introduced the benefit of interest-free loans will be the value received multiplied by the Revenue's official rate of interest each year, less any interest actually paid. Therefore loans that were structured so that the interest was rolled up until the end of the term of the loan, will now result in a taxable benefit on an annual basis, unless the interest is actually paid.

The benefit received from the use of artwork owned by trusts will also now be enshrined in the legislation. The benefit on the use of art will be calculated by multiplying the Revenue's official rate of interest (which is currently 3% per annum) by the acquisition price of the art with a deduction available for any costs actually met by the recipient beneficiary. This treatment is different and less beneficial than current practice. Currently we take the rental value of the art as being equivalent to the annual benefit received – which is commonly as low as 1% of the value of the art

Therefore, in summary, it will be essential to review all loans and benefits within offshore trusts and determine the appropriate treatment going forward as soon as possible.

Given that the rules in relation to offshore trusts have now been amended so as to afford a beneficial regime that allows a deemed domiciled settlor to replicate the remittance basis of taxation (providing no distributions are taken) the question then arises whether it would be appropriate for those who do not yet have such trusts to consider setting them up.

The answer to this question depends on whether the individual concerned has already been resident in the UK in 17 out of the last 20 UK tax years. If they have been so resident, then they are already considered to be deemed domiciled for UK inheritance tax purposes. This brings with it a significant problem, in the form of inheritance tax, on a creation of a new trust.

If the settlor is not yet deemed domiciled then they should definitely consider establishing an offshore trust prior to the introduction of the rules on 6 April next year.

However, if the settlor is already deemed domiciled for inheritance tax purposes then my initial feeling is, unless the assets they are contemplating gifting to the trust qualify for business or agricultural property relief at 100%, that the inheritance tax exposure on the creation of the trust outweighs the benefit.

Prior to the announcements on Monday I and others had been considering whether it might be possible for a deemed domiciled individual to fund a new trust by way of an interest free loan which is left outstanding. However, it appears now that such funding arrangements are likely to constitute "tainting" which would result in the income and gains of the trust being taxed on an arising basis – thereby negating the purpose of the trust. Therefore if any deemed domiciled individual is thinking of establishing a new offshore trust they should proceed with caution and take detailed professional advice prior to doing so.

At the risk of purveying yet more doom and gloom I think it is also important to flag that where an individual becomes deemed domiciled under the 15/20 rule they should not neglect to continue to maintain their domicile of origin abroad.

It would be easy to fall into the trap of assuming that because they are now deemed to be domiciled for all the tax purposes they can make the UK their permanent home. However, if such individuals are relying on the special provisions relating to offshore trusts then it is essential that they retain their domicile of origin overseas. If they fail to do so they will be taxed on the income and gains of the trust on an arising basis.

And it should also be noted that the Revenue have indicated that they will be pursuing enquiries into an individual's domicile position even after they become deemed domiciled.

As had already been announced in July 2015 an inheritance tax charge will be imposed on UK residential property held through offshore structures.

The rules are not yet quite complete but we have a good sense of the direction of travel.

The new rules impose an inheritance tax charge on interests (which includes both loans and shares) in closely held companies which derive their value from UK residential property. The rules will not catch widely held funds such as real estate funds.

The rules also catch an interest in a partnership where the value is attributable to UK residential property. Unlike in relation to companies it does not matter how many partners there are and whether or not those partners are connected.

In an unexpected counter avoidance move the rules are also going to be extended to catch the benefit of loans made for the purpose of acquiring, maintaining or improving a UK residential property or used to invest in a close company or a partnership that uses the money on UK residential property. Further, to avoid back to back lending arrangements, assets that are used as collateral or security for such borrowing will also now be subjected to inheritance tax.

It is therefore not surprising that valuation issues are going to be key.

It should be noted that it is the value of the shareholding, the interest in the partnership or the loan receivable that will be within the scope of inheritance tax and not the value of the underlying property itself, although clearly the two will be closely connected.

This means that it should be possible to benefit from any discounts available for minority shareholdings and obtain a deduction for loans within a company, which are taken out to acquire or enhance the value of the property itself.

However, it will not be possible to secure a deduction for subsequent borrowing using the property as security if the funds so borrowed are not used specifically in relation to the property.

The last specific counter avoidance point to note is that even if the property is sold if there is a chargeable event, such as death or a 10 year charge, within two years of the sale, then the proceeds of sale will be brought into account for inheritance tax purposes.

There will also be targeted anti-avoidance rules which effectively ignore any arrangement intended to sidestep the new rules. It does seem that on this occasion the Revenue have drafted the rules very tightly and very little mitigation or planning will be available to relieve the charge to inheritance tax. As already mentioned the Revenue have extended the exposure to inheritance tax to also cover the right to receive the repayment of any loan which is used to acquire, maintain or enhance a UK dwelling or a loan used to acquire a company or a partnership which owns a UK dwelling.

These rules are likely to have wide reaching effect and in some cases result in apparent double taxation. For example, imagine the situation where the settlor interested offshore trust has made a loan to the settlor in order that he can buy a property. The individual himself will not get a deduction for the debt on the basis the funds have been provided from funds which originated from the settlor. Further the benefit of the debt in the hands of the trustees will now also be subject to inheritance tax - both on the death of the settlor (as he has retained an interest in the trust and has therefore made a gift with reservation of benefit) but also on the 10 year anniversary of the trust.

The rules are also extended to bring into the charge to inheritance tax the value of assets used security, collateral or to guarantee such a debt. These provisions could result in assets used as security with much greater value than the house or the loan itself being brought within the charge to inheritance tax.

With the rules in relation to the taxation of residential property and their extension to loans and collateral being more onerous than originally envisaged it is absolutely essential that any structure holding UK residential property is reviewed as soon as possible, as should any loan or security arrangements which have been put in place in connection with such property.

Although there may be significant costs incurred by restructuring - if restructuring is indeed the right answer - then it will need to be carried out before 6 April 2017. When the changes to the taxation of non-doms was announced the government also indicated that they would be looking to relax the terms of business investment relief to encourage increased investment into the UK.

We have now been provided with the details of what those changes might be. The biggest practical problem with using the relief so far has been in relation to the “extraction of value rule.” This would result in a loss of business investment relief if the individual investor received any benefit from the company invested in. These provisions are now being relaxed so the relief will only be lost if the benefits so received are directly or indirectly attributable to the investment itself. These changes should remove some of the practical difficulties in using the relief and make it more accessible. However, frustratingly, the rules still remain complex.

Helpfully the time limit for investment in a company prior to its starting to trade will be extended from the existing two years to become five years after 5 April 2017.

The extension to the business investment relief which I think will be most helpful is the change that now allows the relief to be claimed on the purchase of existing shares in a qualifying company. Previously the relief was limited to the acquisition of newly issued shares or to loans to qualifying companies.

In the consultation paper the government has indicated that it will continue to look for opportunities to widen the scope of business investment relief and to continue to encourage investment in the UK. So watch this space!

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