FURTHER DEVELOPMENTS FOR U.K. NON-DOM INDIVIDUALS

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Summer is well and truly over, and as everyone started back at the office, H.M.R.C. published its latest consultation document (the "Current Consultation Document") on the proposed changes to be introduced for non-domiciled individuals ("Non-Doms") starting April 6, 2017.

ORIGINAL CONSULTATION DOCUMENT

Some aspects of the proposed changes, including a consultation document (the "Original Consultation Document") and draft legislation, were published in September 2015 as a consequence of announcements made by the U.K. government in the Summer Budget of 2015. The writer commented upon these in a previous edition of *Insights*.[1]

Those proposed changes were as follows:

- Any individual who is a Non-Dom who was born in the U.K. and has a U.K. domicile of origin will be deemed to be domiciled whenever they are resident in the U.K.
- Any individual who is a Non-Dom who has been resident in the U.K. for 15 out of the previous 20 tax years will be deemed to be domiciled in the U.K. from that point on.

At the time of the original announcements, H.M.R.C. also proposed the introduction of relief from the effect of the changes for Non-Doms who would become deemed domicile as of April 6, 2017. For example, one suggestion was to allow Non-Doms to settle assets into a trust in advance of the changes coming into effect.

The Original Consultation Document also stated that H.M.R.C. would take steps to change the rules regarding the holding of U.K. property in overseas corporate structures. Currently, the rules provide certain opportunities to reduce or extinguish stamp duty charges, and to treat both the shares of the company and, as a consequence, the underlying property as excluded from an estate for the purposes of U.K. inheritance tax ("I.H.T.").

SECOND & CURRENT CONSULTATION DOCUMENT

The Current Consultation Document sets out further details and draft legislation regarding the proposals, including protections against the deemed domicile measures and changes to the treatment of property held in overseas corporate structures.

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[1] Gary Ashford, "U.K. Non-Dom Taxation – Where It Is and Where It Is Going," *Insights* 10 (2015).

Some measures are not yet fully covered, such as the Anti-Avoidance Transfer of Assets Abroad rules. It is anticipated that further documents will arrive before April 6, 2017, but the Current Consultation Document provides considerable assistance and guidance on what can be done in anticipation of the April 6, 2017 deadline.

SPECIFIC ISSUES COVERED

Inheritance Tax on U.K. Individual Property

H.M.R.C. previously advised that starting on April 6, 2017, it plans to bring U.K. residential property that is held in an overseas corporate structure under the I.H.T. net. It will do this by introducing legislation that will prevent property held in an overseas corporate structure from being treated as excluded property (and therefore outside the I.H.T. net) if the value of the shares is derived from an interest in a dwelling in the U.K. This rule will apply to both Non-Doms and trusts with settlors or beneficiaries who are Non-Doms.

Background

Many U.K. residential or investment properties are held via corporate structures, and many of those companies are located overseas. In the case of a U.K.-resident Non-Dom, the shares of an overseas company would be non-U.K. situs property. As a result, the underlying property could potentially be treated as excluded property for I.H.T. purposes, so long as the Non-Dom is not yet deemed domiciled and has not settled the shares into an offshore trust.

H.M.R.C. is proposing that property held in overseas corporate structures where the underlying value relates to U.K. property shall no longer qualify as excluded property for I.H.T.

Properties Affected

H.M.R.C. is proposing the application of the new rules to any property which is a "dwelling." The definition of a dwelling was introduced in Finance Act 2015 for the purposes of capital gains tax on disposals by nonresidents of residential property in the U.K. This includes

- Any building which is used or suitable to be used as a dwelling,
- Any building which is in the process of being constructed or adapted for use as a dwelling, and
- The grounds on which such a building is situated.

The new I.H.T. rules will also apply to trustees. The rules will not have any minimum value threshold, nor does H.M.R.C. intend to provide an exclusion for residential properties that are transferred on arm's length terms to a third party or used as a main home.

Changes of Use

H.M.R.C. acknowledges that a residential property may have previously been used for a nonresidential purpose, and therefore, it proposes the introduction of a two-year rule similar to that which currently applies for the purposes of I.H.T. Business

Property Relief ("B.P.R."). This rule states that if the shares in an overseas corporate structure derive their value from a U.K. property I.H.T. will apply if the property was used for a residential purpose at any point in the two years before the I.H.T. event. There will be provisions to apportion I.H.T. charges on a property that has been used for both residential and other purposes at the same time (*e.g.*, property consisting of commercial premises with a flat above).

"H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime."

Debts

In Finance Act 2013, H.M.R.C. tightened the rules by which debt could be used to reduce a liability for I.H.T. purposes. H.M.R.C. has confirmed that it will continue to apply these rules in the new proposals.

As such, any debts which are not related to the property will not be taken into account when determining the value of the property subject to I.H.T., and H.M.R.C. intends to disregard any loans made between connected parties. Furthermore, where an offshore entity holds debts related to U.K. residential property alongside other assets, it will be necessary to take a *pro rata* approach with regard to that debt in calculating the amount of the I.H.T. base.

Administrative Matters

H.M.R.C. is proposing new reporting requirements so that a property cannot be sold until any outstanding I.H.T. charges are paid. Under this provision, a new liability may be imposed on any person who has legal ownership of a property, including the directors of a company that holds a property, to ensure that I.H.T. is paid. The relevant legislation will be published later in 2016. These rules will apply to all chargeable events that take place after April 6, 2017.

Deemed Domicile Rules for Long-Term U.K. Residents

Background

Prior to the release of the Current Consultation Document, H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime. A specific deemed domicile rule already exists for I.H.T. purposes, under which Non-Doms resident in the U.K. for 17 out of the previous 20 years are deemed to be domiciled in the U.K (the "17/20 Rule"). However, the new proposal would establish a general cap on the number of years that the Non-Dom regime could apply, after which any resident Non-Dom would be taxed on the arising basis[2] in the U.K. in the same manner as all other U.K.-resident and domiciled citizens.

H.M.R.C. has already issued draft legislation for this proposal. It will deem those individuals who were U.K. residents in 15 out of the previous 20 tax years as domiciled in the U.K. for both income tax and capital gains tax purposes (the "15/20 Rule"). The proposed new rule will essentially follow the same principles as the 17/20 Rule, albeit for a shorter threshold period, and will include any years in the U.K. under the age of 18. The new shorter deemed domicile period will also apply for I.H.T. and will replace the 17/20 Rule.

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2 Under the arising basis, income is taxed when and as it arises. Remittance to the U.K. is immaterial.

H.M.R.C. has confirmed that an individual can "lose" their U.K. domicile status if they become nonresident and spend at least six years overseas (four years for I.H.T. purposes).

Updates Within the Current Consultation Document

An interesting and significant point in the Current Consultation Document is that H.M.R.C. has confirmed that the residence tests will follow current law, which is a combination of the Statutory Residence Test for tax years 2012-2013 onwards and existing case law for prior years, as there was formerly no real legislation in this area. Given the historical problems that have arisen from uncertainties over residence under common law, one can see that application of the residence tests may not be as straightforward to apply as H.M.R.C. intends.

In the Current Consultation Document, H.M.R.C. clarified that split tax years will be counted towards one of the 15 years under the proposed deemed domicile rules.

Protections Proposed to Lessen the Impact of the Changes

Capital Gains Tax

H.M.R.C. proposes that individuals who will be deemed domiciled on April 6, 2017 under the 15/20 Rule shall be able to rebase directly-held foreign assets to the market value of the assets on April 5, 2017. Those individuals who become deemed domiciled after April 2017 and those who are deemed domiciled because they were born in the U.K. with a U.K. domicile of origin will not be able to rebase their foreign assets.

Mixed Funds Opportunity

A welcome development within the Current Consultation Document is that H.M.R.C. is introducing a window to clean up mixed funds.

Prior to arrival in the U.K., it is always advisable for a future Non-Dom to segregate his or her banking accounts into pre-arrival capital, income, and gains – in addition to a few other categories. The purpose of this is essentially to maintain the character of each component of the account so that any future remittance to the U.K. will be taxed at the appropriate rate, *i.e.*, 45% income tax, 28% capital gains tax (recently reduced to 20%), and to distinguish capital, which can potentially be brought into the U.K. without any tax charge.

Where segregation has not taken place, mixed funds arise and any future remittance will therefore contain a mixture of the various parts. There are specific rules for mixed funds that essentially tax any part of the funds at the highest rate first (*e.g.*, as income). Without a significant amount of work, H.M.R.C. might well contend that the whole remittance should be taxed at 45%.

Under the latest proposals, Non-Doms with mixed funds will have the opportunity to review the funds and separate out the different parts into clean capital, foreign income, and foreign gains. They will then be able to remit from the newly-segregated accounts as they wish. There will be no requirement for Non-Doms to make remittances from their newly-segregated accounts in any particular order or within any particular period of time.

This special treatment will apply only to mixed funds that consist of amounts deposited in banking and similar accounts. Where the mixed funds take the form of assets, an individual will have to sell any overseas assets during the transitional window and separate the sale proceeds in the same way as any other money.

To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds. This opportunity will be available to any Non-Dom, including those born in the U.K. without a U.K. domicile of origin and individuals who will be deemed domiciled under the new rules. An individual need not be resident in the U.K. in April 2017. This window for this benefit will last for one tax year from April 6, 2017.

The matter of whether a trust, treated as a relevant person under the remittance rules, will also be able to clean up its mixed funds is currently not clear. It would appear logical to allow this, but we will have to wait and see.

"To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds."

Nonresident Trusts

Nonresident trusts have always been very useful to Non-Dom clients, as they allow for non-U.K. situs assets to remain outside the U.K. estate for I.H.T. purposes, even beyond the point that the 17/20 Rule starts to apply, when settled before that point. Additionally, Non-Dom settlors and/or beneficiaries claiming the remittance basis are only taxed on income or gains to the extent they are remitted to the U.K.

H.M.R.C.'s proposal to deem those who fall under the 15/20 Rule as U.K. domiciled for all taxes potentially has significant effects for Non-Doms holding assets in nonresident trusts. Whilst the proposed rule simply reduces the threshold of the current I.H.T. deemed domicile rule by two years, any Non-Dom individual who is deemed domiciled would not be able to use the remittance basis. As a result, where these individuals receive distributions or have an interest in income and gains from a trust, they would then be liable for tax on any resulting income or gains.

To limit the burden of the proposed changes, H.M.R.C. has again proposed certain protections. One proposed protection is that Non-Doms who set up offshore trusts before they are deemed domiciled under the 15/20 Rule will not be taxed on trust income and gains that are retained in the trust or its underlying entities. Another proposed protection is that excluded property trusts will have the same I.H.T. treatment as at present (except where there is U.K. property, as discussed below).

Proposed Changes for Specific Taxation Areas for Nonresident Trusts

Attribution of Gains to Settlors (§86 T.C.G.A. 1992)

Section 86 taxes chargeable gains on any individual who is resident and domiciled in the U.K. and who has an interest in settled assets that are held in a nonresident trust or which are attributable to the trustees via an underlying company. The current §86 rules do not apply to Non-Doms, meaning that Non-Doms with an interest in an offshore trust will only be taxed on gains that are distributed to them and, even then, only when those gains are remitted to the U.K.

Under the proposed changes, §86 will be extended to include Non-Doms who are deemed domiciled. In order to mitigate the effects of this new application, H.M.R.C. is proposing to tax the Non-Dom only on any gains in relation to a trust established prior to becoming deemed domiciled when any distribution is made to the Non-Dom or a member of the Non-Dom's family. In this context, a family member is defined as the settlor, the spouse, or children under the age of 18. Additions made to a trust after the changes come into force will also potentially take away the protections.

The protections above will not be afforded to any person who is deemed domiciled as a result of having been born in the U.K. with a U.K. domicile of origin. Furthermore, any gains being taxed on the settlor under these proposals will be matched to the underlying gains in the nonresident trust.

Attribution of Gains to Beneficiaries (§87 T.C.G.A. 1992)

Section 87 taxes any U.K.-resident individual on capital payments they receive from a nonresident trust to the extent that there are chargeable gains arising in that trust. The legislation applies regardless of the individual's domicile status and includes, *inter alia*, the settlor of the trust. However, those currently taxed under §87 can elect to apply the remittance basis.

Following the introduction of the new deemed domicile rule and the proposed changes to §86 mentioned above, settlors of trusts will no longer be taxed under this clause. It is proposed that U.K.-resident individual beneficiaries who receive capital payments or benefits from a nonresident trust or underlying entity and who are deemed to be domiciled in the U.K. will be subject to capital gains tax under §87, regardless of where the benefits are received. The current rules of matching underlying gains in the nonresident trust to distributions will continue.

Settlements Legislation (§624 I.T.T.O.I.A. 2005)

The settlements legislation is an income tax provision which taxes any income of an individual settlor who has retained an interest in a settlement, including a nonresident trust. The legislation also taxes the settlor on any income arising to the settlor's unmarried minor children, on capital payments from a nonresident trust, on loans, and on capital payments made by bodies associated with a nonresident trust. Currently, where U.K.-resident Non-Doms are potentially taxed under this provision, those who claim the remittance basis are taxed only on foreign-source income remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident deemed domiciled individuals on a worldwide arising basis, and where the legislation applies, they may be liable for tax on all income arising in the nonresident trust. H.M.R.C. is proposing additional protections so that deemed-domiciled individuals will be taxed on income of a nonresident trust set up before they were deemed domiciled only to the extent that a "family benefit" is conferred. A family benefit is conferred where any of the protected income is applied for the benefit of or paid to any of the following:

- The settlor
- The spouse
- A minor child or grandchild
- A closely-held company in which a participator falls within the scope of the settlements legislation
- The trustees of a settlement of which a beneficiary falls within the scope of the settlements legislation

- A body connected with such a settlement

Anti-Avoidance for Transfers of Assets Abroad (Chapter 2, Part 13 I.T.A. 2007)

The Transfer of Assets Abroad legislation ("T.o.A.A.") is anti-avoidance legislation designed to prevent U.K.-resident individuals from avoiding U.K. income tax by transferring the ownership of assets to persons abroad while still being able to enjoy the benefit of the income generated by those assets. Essentially, T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements. H.M.R.C. taxes transferors on the underlying income, or transferees (including beneficiaries) on the amounts they receive. Currently, T.o.A.A. allows for any individual claiming the remittance basis to be liable for income tax only on U.K.-source income and foreign income that it is remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident, deemed-domiciled individuals on any foreign income arising in or paid by a structure, wherever it is received. However, H.M.R.C. is proposing changes that partially remove the application of the provisions of the T.o.A.A. legislation that would affect deemed-domiciled settlors who set up a nonresident trust before they become deemed domiciled. This is to prevent them from being taxed on the foreign income of the trust or any underlying entity paying out dividends to the trust.

Under the proposed new rules, H.M.R.C.'s intention is that, rather than being taxed on the arising basis, foreign-source income will be taxed at the time any benefits received. If the settlor, the spouse, a minor child, or other relevant person receives any actual benefits from the trust – *e.g.*, by way of an income or capital distribution or enjoyment of trust assets – the distribution will trigger the imposition of tax on the settlor to the extent that it can be matched against relevant foreign income arising in that year.

"T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements."

The full details of the proposed changes to the T.o.A.A. provisions have yet to be released. However, the details provided to date appear to suggest that some of the same principles under which beneficiaries are currently taxed on gains under §87 T.C.G.A. (see above) will be applied to the underlying income of the trust (*i.e.*, the distribution will be matched and taxed accordingly). H.M.R.C. has advised that it will publish further details on these proposed changes later in the year.

Born in the U.K. with a U.K. Domicile of Origin

H.M.R.C. has already stated that it proposes to treat any individual born in the U.K. with a U.K. domicile of origin as U.K.-domiciled while they are resident in the U.K.

Many, if not all, of the protections being proposed by H.M.R.C. to lessen the impact of the April 6, 2017 changes will be denied to those caught under this provision. This includes the opportunity to make settlements into nonresident trusts prior to arrival in the U.K. The resulting nonresident trusts would be treated as relevant property trusts once the individual becomes resident in the U.K.

However, H.M.R.C. is offering some relief from these provisions. For the purposes of I.H.T., the individual will not be treated as being domiciled in the U.K. until they have been resident for at least one of the two tax years prior to the year in question.

This would apparently provide some opportunity to settle matters in trust before becoming resident in the U.K. Whilst the resulting trust would be a relevant property trust when the individual is resident, the assets may still effectively sit outside the U.K. estate for I.H.T. purposes. However, it is understood that these individuals will be taxed on a worldwide basis for income tax and capital gains from the point they become U.K. residents.

Business Investment Relief

Building on the government's 2015 Autumn Statement, H.M.R.C. has also set its interest on ways business investment relief ("B.I.R.") may be modified to encourage foreign investment in U.K. business by remittance basis users. Clearly, given June's Brexit referendum result, one may suggest that this issue has risen to even greater prominence than when the 2015 Autumn Statement was first issued.

For those unfamiliar with B.I.R., it provides an exemption to the remittance basis rules that was introduced on April 6, 2012. B.I.R. helps U.K. businesses to attract inbound investment by allowing individuals who use the remittance basis to bring overseas income and gains to the U.K. without any tax liability if it is done for commercial investment purposes. The scheme effectively treats funding for qualified investments as if not remitted to the U.K. and therefore not liable to tax.

The range of companies in which a qualifying investment can be made under the scheme is quite wide. The definition includes an investment in:

- A company carrying on a commercial trade or preparing to do so, including one whose activities consist of generating income from land,
- A company carrying out research and development activities,
- A company making commercial investments in trading companies, and
- A holding company of a group of trading companies.

There are no restrictions preventing the scheme from being used for investments in a company with which an investor has a separate involvement, such as holding a director's position and receiving arm's length compensation for services provided in the ordinary course of business. Any investment must be made within 45 days of the date on which the funds are brought into the U.K.

Unlike other government schemes designed to encourage investments, there is no monetary limit on an individual's investments under B.I.R. However, the scheme is not available for investments to acquire existing shares nor is it available for investments in companies that are listed on a recognized stock exchange.

H.M.R.C. has indicated that any changes to B.I.R. would feature in Finance Bill 2017 and therefore be introduced on April 6, 2017.

CONCLUSION

Despite the Brexit vote, the U.K. government appears to be committed to limiting some of the benefits of the Non-Dom rules. However, for the newly arrived non-U.K.-born Non-Dom, there are still great opportunities and potentially 15 years of full benefits under the Non-Dom regime.

Even when the 15-year threshold has been reached, the individual in question has choices. The individual might, for example, settle assets into a trust. Provided that there are no distributions to family members, the assets could potentially sit within that trust without encountering taxable consequences. Various trust-related options will likely be considered between now and April 6, 2017, along with various other options that may provide for income tax deferment, such as an offshore life insurance bond.

Alternatively, some Non-Doms may actually decide to leave the U.K. – at least for a sufficient amount of time to reset the 15-year clock. For those who choose to do this, it is worth remembering that, depending on the circumstances, they may still have quite a generous allowance of days, which grants them continued access to the U.K. Departure need not amount to an all-or-nothing solution.