U.K. DROPS CHANGES TO NON-DOMICILE REGIME, BUT LIKELY NOT FOR LONG

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After months of H.M.R.C. consultation, it seemed a new regime for non-domiciled U.K.-resident individuals ("Non-Doms") was finally set to take effect on April 6, 2017. That was until the enacting legislation was suddenly pulled from Finance Bill 2017.

In an effort to hasten parliamentary approval ahead of the snap election on June 8, 2017, 72 of the 135 clauses were removed from Finance Bill 2017 on April 25, 2017. This allowed the Parliament to condense the customary two days of House of Commons debate, standing committee sessions, and an additional two days of report stage and third reading debate into a mere two hours.

The changes to Non-Dom taxation are the most significant since 2008 and follow a lengthy consultation period, during which several clarifications and modifications were made and numerous provisions were delayed as it was not possible to agree on final language. In many respects, this latest delay does not come as a surprise given the slow pace of the consultation process – for the portion dealing with trusts alone, the consultation period ran from December 5, 2016, to February 22, 2017.

Although the revised Non-Dom legislation has not been adopted, it is expected that the agreed-upon clauses, as outlined below, will appear in a later bill. Subject to the election result, enacting legislation could be passed as early as this fall with effect from April 6, 2017, upon enactment. Other proposed changes, which were delayed prior to the parliamentary vote, may be adopted in a later finance bill, presumably Finance Bill 2018.

DEEMED DOMICILE

The main revisions call for individuals who are not actually domiciled in the U.K. to be deemed domiciled for all U.K. tax purposes if either of the following fact patterns apply:

- They have been resident in the U.K. for 15 of the previous 20 tax years (the "15/20 Rule").
- They were born in the U.K. with a U.K. domicile of origin and they are resident in the U.K.

Under the revised regime, U.K.-resident Non-Doms who fall into either of the above categories will lose the opportunity to claim the remittance basis of taxation and will be subject to tax on worldwide income and gains from April 6, 2017. The pre-existing rule – under which Non-Doms who have been resident in the U.K. for 17 of the previous 20 tax years (the "17/20 Rule") are deemed to be U.K. resident for inheritance tax purposes – will all be aligned to the 15/20 Rule.

CAPITAL GAINS TAX REBASING

Non-Doms who become deemed domiciled on April 6, 2017, under the 15/20 Rule will be afforded some relief from capital gains tax on pre-existing gains through a step-up in basis to the value of the assets as of April 5, 2017. This relief will be available only to those who at some point prior to April 6, 2017, prepared tax returns under the remittance basis and paid the remittance basis charge ("R.B.C."). Non-Doms who have never paid the R.B.C. will be required to do so during the 2016-2017 tax year in order to benefit from the step-up in basis. The tax return deadline for claiming remittance basis tax and paying R.B.C. is January 31, 2018.

Certain limitations apply to Non-Doms wishing to benefit from the step-up in basis. First, the step-up in basis will be available only to assets owned as of March 16, 2016, that have been treated as being located outside the U.K. at all time through April 5, 2017. Second, Non-Doms born in the U.K. and having a U.K. domicile of origin cannot access this relief.

CLEAN UP OF MIXED FUNDS

U.K.-resident Non-Doms will also be given the opportunity to reorganize their non-U.K. bank accounts containing mixed funds. In anticipation of the enactment, many clients may want to consider splitting out such funds into separate accounts to facilitate tax-efficient remittances to the U.K. Under the agreed-upon clauses, the separation must be completed it prior to April 5, 2019.

This opportunity will be open to Non-Doms whether or not they become deemed domiciled on April 6, 2017. However, they must have reported income under the remittance basis of taxation at some point prior to the April 6, 2017, cutoff and, where appropriate, paid the R.B.C. As with many of the proposed changes, U.K.-resident Non-Doms who were born in the U.K. with a U.K. domicile of origin will not have the opportunity to cleanse mixed funds.

The Spring 2017 Budget included a statement that the opportunity to separate mixed funds will cover years ending prior to April 6, 2008. However, language to that effect was not part of draft legislation. A correction is expected post-election.

As of April 6, 2017, a new "Requirement to Correct" offense will also be instituted. If noncompliance in an earlier year is identified when undertaking the clean up a mixed fund, an obligation to correct likely will be imposed on the U.K.-resident Non-Dom, perhaps by way of a disclosure to H.M.R.C.

PROTECTION FOR NON-DOM SETTLORS

During the consulation process, various transitional rules were proposed to potentially soften the introduction of the revised Non-Dom regime.[1] These included protections for individuals becoming deemed domiciled on April 6, 2017, who set up nonresident trusts prior to becoming deemed domiciled.

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1 For more information, see Gary Ashford, "U.K. Non-Dom Taxation – Where it is and Where it is Going," *Insights* 10 (2015); see also Gary Ashford, "Further Developments for U.K. Non-Dom Individuals," *Insights* 9 (2016).

H.M.R.C. set out the first draft legislation on December 5, 2016, within the draft Finance Bill 2017. However, it was not until January 27, 2017, that H.M.R.C. published draft legislation regarding income tax, including the proposed amendments to the Transfer of Assets Abroad ("T.O.A.A.") legislation.

In general, U.K.-resident and domiciled settlors holding an interest in an overseas trust are taxed on all capital gains within the trust on an arising basis. The current rules exclude Non-Dom settlors. Therefore, they are taxed under the rules for beneficiaries, which provide only for taxation in relation to distributions, matched to any gains within the trust. Under these provisions, a Non-Dom has the opportunity to apply the remittance basis to limit any tax on gains resulting from U.K.-situs assets or overseas gains to the extent remitted to the U.K. Without the proposed protections, Non-Doms who become deemed domiciled on April 6, 2017, will become liable to tax on all capital gains arising in any trust, in the same way as U.K.-resident and domiciled settlors.

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The transitional rule will prevent a deemed domiciled Non-Dom from being taxed on an arising basis and will defer taxation of capital gains to the time of distribution, without further benefit under a remittance rule. Note that the transitional rule will not be available to any Non-Dom who is deemed U.K. domiciled by virtue of being born in the U.K. with a U.K. domicile of origin. Those individuals will be taxable on all capital gains that arise within a trust.

Under the current regime, the pot of capital gains available to be matched can be reduced through certain methods, including capital payments made to nonresident or temporary nonresident beneficiaries and distributions linked to the cessation of the trust where at least one of the recipient beneficiaries is a nonresident. Attempts to limit the scope of these planning opportunities were not part of the final legislation. If enacted, these limitations will not come into effect before April 6, 2018, thereby providing taxpayers with additional time before the full impact is realized.

Additionally, where distributions are made to a beneficiary who is a close family member (*e.g.*, a spouse, civil partner, or minor child) that is a nonresident with regard to the U.K., or is a Non-Dom U.K.-resident reporting income on the remittance basis, tax will be imposed on the deemed domiciled settlor if the gains are not remitted to the U.K.

Where the settlement legislation applies, the settlor will be taxed on the income of the trust on an arising basis. This treatment is subject to transitional relief. If a trust is set up before the settlor becomes deemed domiciled and no further contributions of property are made to the trust, the settlor will be taxed in the year a distribution is received, not when it arises in the trust. Similar treatment is provided where a close family member receives a benefit from the trust. Relief under the transitional rule will not be extended to individuals who become deemed domiciled due to having been born in the U.K. with a U.K. domicile of origin.

It is expected that the T.O.A.A. rules will be amended to align with the protected income rules found in the settlements legislation, but only if included in Finance Bill 2018.

RESIDENTIAL PROPERTY AND INHERITANCE TAX

The draft legislation within Finance Bill 2017 stated that property would not be excluded property for inheritance tax purposes in a number of cases where the value is directly or indirectly attributable to U.K. residential property. Thus, where a nonresident entity owns U.K. real property, the interest in that entity will be subject to inheritance tax upon the death of the interest holders.

Interest covered by this rule includes (i) a right or an interest of more than 1% in a close company, (ii) an interest in a partnership, or (iii) an interest in a debt instrument that is a relevant "relevant loans." In this context, a relevant loan is a loan used to directly or indirectly finance the acquisition, maintenance, or enhancement of, or to procure a right to acquire, maintain, or enhance, U.K. residential property. A relevant loan is also one used to acquire an interest in a close company to the extent that the loan finance is used to acquire, maintain, or enhance U.K. residential property. The changes will effectively prohibit a widely-used planning strategy whereby a Non-Dom buys a U.K. home through a foreign company so as to remain outside of the U.K. inheritance tax net.

Many clients have been reviewing these structures in recent months, as in some cases, under the new rules, no benefit remains in using a company for this purpose, particularly in light of the annual costs and taxes. Instead, many have decided to "de-envelope" their U.K. property so that it is held personally. De-enveloping may likely be subject to significant costs, such as capital gains tax and stamp duty land tax charges. Nonetheless, in light of the political stance being taken by H.M.R.C. on offshore structures, de-enveloping may be worth the cost.

In computing value for inheritance tax purposes, debt will remain deductible after the April 6, 2017, effective date. However, offsetting it against a property's value to potentially reduce the attributable value for inheritance tax purposes may bring added complications, in that the loan will be subject to inheritance tax within the estate of the lender. This may, of course, discourage lenders from making such loans and would certainly introduce significant complexity into arrangements involving loans.

BUSINESS INVESTMENT RELIEF

To date, no draft legislation has been published in relation to the revised rules for business investment relief ("B.I.R."), however the issue is likely to resurface post election.

B.I.R., in its current form, was introduced on April 6, 2012. The purpose of this relief is to allow U.K.-resident Non-Doms who have claimed the remittance basis to bring foreign income or gains to the U.K. for investment in a targeted company without triggering the R.B.C. The investment can be made in the form of money or other property derived from foreign income and gains, or in the form of shares or a loan to the target company, so long as it originates from years in which a person was taxed on the remittance basis.

Several conditions must be met to benefit from B.I.R.:

- The investment must be a qualifying investment.
- It must be made in a target company within 45 days from the date funds are brought to the U.K.
- B.I.R. must be claimed on a self-assessment tax return.

Investments are qualifying investments where two conditions are met:

- The target company must be (i) an eligible trading company, (ii) an eligible stakeholder company, or (iii) an eligible holding company.
- No relevant person receives any benefit directly or indirectly from the target company or any company associated with it, whether or not the benefit is connected to the investment.

In terms of the first condition, qualifying companies are those that carry on a trade or generate income from land (including property), make investments into such companies, or hold shares in such companies. Note that a start-up period is allowed before a commercial trade is first carried on. Under prior law, the start-up period was capped at two years.

Under the revised regime, the cap on the start-up period will be expanded to five years, effective April 6, 2017. The new rules will extend the definition of a qualifying investment to include the acquisition of both existing shares and new shares in qualifying target companies. It will also clarify that the corporation must carry on trading activities itself. Activities of partnerships will not qualify for B.I.R.

When a company ceases its commercial operations, the investment of the U.K.-resident Non-Dom must be removed from the U.K. within a short period of time, which can be as little as 45 days. The changes to B.I.R. will extend the period for removal of funds so that it may be as long as two years from the date upon which the investor becomes aware of the cessation of trading activities.

LEGISLATION TO BE PUBLISHED IN A FUTURE FINANCE BILL

As previously mentioned, various proposals were delayed prior to the parliamentary vote on April 25, 2017. It is expected that H.M.R.C. will publish further draft legislation to address open items, presumably in Finance Bill 2018. A summary of the anticipated legislation is set out below.

Computation of Capital Gains Tax on U.K. Deemed Domiciled Settlors of Foreign Trusts on the Arising Basis, T.C.G.A., Schedule 5

- Disregard of §87 capital payments to nonresidents in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Disregard of §87 capital payments to migrating beneficiaries in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Transfer of §87 benefits charged to the settlor where the beneficiary is a close family member of the settlor and is not liable to capital gains tax on the payment in connection with gains realized by foreign trusts
- Attribution of gains to recipients of onward gifts (recycling rule)

Chapter 5 of Part 5 of I.T.T.O.I.A. (Settlements)

- Benefits charge for foreign domiciled settlors and deemed domiciled settlors in respect of benefits received by the settlor or close family member such as a spouse, cohabitee, or minor child (not including a minor grandchild)

- Benefits charge on settlor when beneficiary receiving benefits is close family member but is not taxable on the benefit
- Attribution of deemed income to a U.K.-resident recipient of a gift when a trust having income makes payments to nonresidents or remittance basis users who hold the money for a period of time before giving or lending it back to a beneficiary in the U.K. (tracing to stop when more than three years lapse between distribution and gift)

One question that remains is whether future legislative action on these items will be effective as of April 6, 2017.

CONCLUSION

For the time being, the U.K. Non-Dom rules live on in full force. However, subject to the result of the snap election, the revised provisions will likely be enacted within the year. While the changes slated for April 6, 2017, limit some of the opportunities provided by the Non-Dom regime, the remaining opportunities will still be quite significant. As has been the case since April 2008, arriving U.K.-resident Non-Doms will have seven years of access to the remittance basis regime with no cost. Thereafter, the R.B.C. will remain at £30,000 until the individual has been resident for 12 years, after which point it will increase to £60,000. The main changes to the legislation are focused on long-term residents (soon to be 15 years) and those born in the U.K. with a U.K. domicile of origin.

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Clients who would become deemed domiciled on April 6, 2017, should review their investments and, where appropriate, segregate those made before April 6, 2017, from those made after April 6, 2017. Consideration should also be given to investments that defer the point of taxation, such as bonds, equities, or funds. Consideration should be given to the impact of rebasing, whether positive or negative, and action taken accordingly.

B.I.R. remains a very attractive option and will become even more attractive going forward. For those who would become deemed domiciled on April 6, 2017, the soft landing provided by a step-up in tax basis and the two-year window in which to clean up mixed funds will be helpful. Non-Doms will be able to revisit their investments and potentially identify and extract or use clean capital in a variety of imaginative ways. In cases where it would be practically difficult to clean up a mixed fund, B.I.R. may allow such funds to be used in the U.K. without triggering an R.B.C.

In light of recent political shifts, the U.K. government is keen to make known to the world that the U.K. – and particularly the Non-Dom regime – is very much "open for business" and will remain so for newly arriving individuals not having been born in the U.K. with a U.K. domicile of origin. This delay affords clients a unique opportunity: additional time to plan for the past.