Analysis

Finance Bill 2017: the non-dom reforms

Speed read

Many of the draft Finance Bill 2017 changes are as expected – although not entirely so for the new 'protected settlements' regime. Unfortunately, though, what the draft Finance Bill doesn't do is to go very far in making the business investment relief rules more favourable. There is some relaxation of the extraction of value rule; an ability to now buy shares rather than just subscribe for them; and the two year set up rule has been extended to five years. Otherwise, we will have to wait for further consultation for some more meaningful changes. It is also fairly clear that some of the draft Finance Bill 2017 legislation will require some further work to obtain the necessary clarity before it hits the statute books. For sure, though, non-doms who will become deemed domiciled on 6 April 2017 will need to now hurry up and make sure their planning is attended to ahead of the proposed rule changes.

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HMRC has now consulted on various proposals put forward by the chancellor, and the result is the draft of legislation outlined below. As can be noted from previous editions of *Tax Journal*, there have been changes along the way. HMRC has given some reliefs for those who became deemed domiciled in the UK from 6 April 2017, with some transitional reliefs, the opportunity to 'cleanse' mixed accounts and the option for those who have paid the remittance basis charge (RBC) to rebase their non-UK assets at April 2017. There was also a major change in the way that trusts were taxed, with a proposal that all distributions were taxed in the UK. This proposal was thankfully dropped in favour of protecting trusts that have not been touched after the settlor became domiciled in the UK. This does mean that a trust can be 'tainted', effectively meaning that the property within the trust can be traced only where the beneficiary is resident in the UK.

Deemed domicile: income tax/CGT definition

A new definition of deemed domicile for income and capital gains tax purposes is introduced by Finance Bill 2017 cl 40. FB 2017 cl 41 deals with inheritance tax deemed domicile.

New s 835BA of ITA 2007 inserts two new conditions (expressed in the alternative) which, if met, will mean that an individual who is otherwise a non-dom will be anyway regarded as domiciled:

- Condition A: the individual was born in the UK, had a domicile of origin in the UK and is UK resident for the relevant tax year (AKA 'bad non-doms').
- Condition B: the individual has been UK resident for at least 15 out of the 20 tax years immediately preceding the relevant tax year (AKA 'good non-doms').

However, condition B is not met if the individual is not UK resident for the relevant tax year *and* there is no tax year beginning after 5 April 2017 and preceding the relevant tax year in which the person was UK resident. In other words, someone who may have suddenly become a deemed dom under the 15/20 year rule next tax year, due to time previously spent in the UK, will not in fact become a deemed dom for a given year, if actually they leave the UK in the current tax year and become non-UK resident.

The IHT deemed domicile rules don't have the 'resident in the year' condition; therefore, if an individual meets the 15/20 year test they are deemed domiciled for IHT for the next three years.

Transitional provisions are available in relation to TCGA 1992 s 10A to largely alleviate the impact of the 15/20 year deemed domicile rule, where taxpayers return part way through the tax year.

Deemed domicile: s 16ZA losses (FB 2017 Sch 12)

Section 16ZA is amended so that once an individual is deemed domiciled, the election (if previously made) will cease to have effect for the year in which the individual becomes deemed domiciled, and subsequently.

Even if someone has made an election, it has no effect from the year that they become domiciled in the UK. This is useful, as it puts a time limit on a previously unlimited irrevocable election – the election will then only last for 15 years, after which the individual will be taxed on the arising basis, but there could be some planning around this.

A new election can be made later if appropriate; for example, if the individual leaves the UK for six tax years and then returns.

If an individual loses their domicile status (presumably just by being out of the UK for six years), then they go back to non-dom and will have to consider the election again if they claim the remittance basis.

CGT rebasing (FB 2017 Sch 12 paras 21–23)

The ability for individuals that become deemed domiciled on 6 April 2017 to 'rebase' is something of a gift, basically to compensate such individuals for their change in tax status. However, it applies only to individuals becoming deemed domiciled on 6 April 2017; frankly, it was deemed by government to be too expensive to extend the rebasing any further.

The key requirements for rebasing to market value as at 6 April 2017 are that:

- The individual holds the asset on 5 April 2017.

- The individual disposes of the asset on or after 6 April 2017.
- The asset was not situated in the UK at any time in the relevant period (being from 16 March 2016 or, if later, the date on which the individual acquired the asset, and ending on 5 April 2017).
- The individual is a qualifying individual, meaning that he or she:
  - must have made a remittance basis claim under s 809H (the individual paid the RBC), e.g. having been UK resident for the requisite seven tax years or more) for any tax year before the tax year 2017/18;
  - cannot be a 'bad non-dom'; and
  - must be a 'good non-dom' throughout tax year 2017/18; i.e. the individual is non-domiciled under general law but is deemed domiciled under the 15/20 year rule (and also each year subsequently if the disposal was made subsequently, up until the year of disposal – known as the 'relevant years').

An individual may make an election for para 21 not to apply 'to a disposal' made by the individual. The drafting of the legislation currently seems unclear as to whether this opt out is therefore on an asset by asset basis or not, though one would hope that government will clarify this shortly.

An election to opt out is irrevocable.

It is interesting to note that it is possible to fall into being deemed domiciled under the 15/20 year rule but to never have paid, or had the opportunity to pay, the RBC. For example, if someone left the UK so they broke the seven/nine rule and could keep filing on remittance basis without paying the RBC, they could be in this situation. This would mean that such a person becoming deemed domiciled could not get the CGT uplift.

Cleansing of mixed funds (FB 2017 Sch 12 para 24)

'Cleansing' gives the taxpayer the ability to transfer funds out of a mixed fund account and into a new account, to split out different elements of that mixed fund.

Although initially we were told that there would be a year's window to operate 'cleansing' (in 2017/18), actually the FB 2017 provisions are such that 'cleansing' can apply for transfers made in tax year 2017/18 or 2018/19.

In order to qualify for 'cleansing', the following conditions must be met:

- The individual must make a transfer of money out of a mixed fund bank account. (Although the legislation does not specifically say as much, presumably the transfer can only be to another bank account; and it will generally make sense for that bank account itself to be either a new account or one with no other funds in it).
- At the time of the transfer, the individual then makes a 'nomination'.
- The individual must be a 'qualifying individual'. This means that either s 809B to s 809D or s.809E must have applied for any tax year before the tax year 2017/18 (i.e. the individual must have claimed the remittance basis, albeit paying the RBC is not a prerequisite). The individual must also be a 'good' non-dom.

IHT and UK residential property (FB 2017 Sch 13)

From 6 April 2017, property will no longer be excluded property (whether owned personally or through a trust) where:

- in respect of rights or an interest that a participator has in a close company, if and to the extent that the value of the right or interest is directly or indirectly attributable to a UK residential property interest (although interests or rights below 1% of the value of the company can be ignored);
- in respect of an interest in a partnership, if and to the extent that the value of the interest is directly or indirectly attributable to a UK residential property interest; and
- in respect of debt, the debt is caught by the new 'relevant loans' rules – being essential loans for the acquisition, maintenance or enhancement of UK residential property.

Note that companies have to be close, but partnerships don't.

The effect of this new rule will mean that:

- individuals owning interests in close companies or partnerships, or debts whose value is directly or indirectly attributable to UK residential property, will be within the IHT charge on death, on transfer to a trust or within the PET rules; and
- trustees owning interests in close companies or partnerships, or debts whose value is directly or indirectly attributable to UK residential property, will be within the IHT charge under the 10 year charge regime, on transfers in of new property within these rules, or on the death of the settlor if the gift with reservation of benefit rules are in point.

Loans

Initially there was some talk of restricting the deductibility of debt against the IHT charge. However, in FB 2017 we see no (new) restriction on debt (although, of course, existing legislation on the 'relevant debt' rules does already contain some quite heavy restrictions).

What we now see in FB 2017 is that, as well as interests in close companies and partnerships falling outside of the excluded property rules where the value of those interests are directly or indirectly attributable to UK residential property, the rights of a creditor in respect of a 'relevant loan' and also money or money's worth held or otherwise made available as a security, collateral or guarantee for a 'relevant loan' will also fall outside of the definition of excluded property.

Calculation issues

In determining the value of a right or interest in a close company for the purposes of determining the extent of the IHT charge, liabilities of the close company are to be attributed to all of its property rateably (whether or not they would otherwise be attributed to any particular property of the company).

It seems clear from the legislation that it is still the value of the shares or partnership interest that are being charged for IHT purposes (albeit only to the extent that their value is directly or indirectly attributable to a UK residential property interest). As such, when valuing those shares, one would take into account discounts for minority interests, for example.

When considering the disclosure and transparency rules (DTR) position, Sch 13 para 7 adds in a proviso that DTR provisions will not prevent there from being an IHT charge under these new rules where there is no IHT charge in the other country concerned.

Two year tail

Once property is within the exception to the excluded rules (i.e. because it relates to an interest in UK residential property), there will now be a two year tail, under which the consideration for the disposal of such an interest, or any property directly or indirectly representing that interest, will still be within the charge to UK IHT.

The two year tail will commence with the date of the disposal of the interest in shares, a partnership or a relevant loan where the new IHT rules apply; or, for creditors, the date on which the debt is paid.

Definition of residential property

The new IHT rules essentially borrow the definition for residential property that one finds in the definition of non-resident capital gains tax (NRCGT) (TCGA 1992 Sch B1).

Taxation of offshore trusts

Capital gains rules

A new sub-s (3A) is inserted into TCGA 1992 s 86 to provide that ITA 2007 s 835BA applies for the purposes of sub-s (1)(c). However, s 86 is otherwise unchanged. Effectively, therefore, once an individual is deemed domiciled in the UK, the provisions of s 86 will apply to an offshore trust settled by him, which is regarded as settlor interested (remembering that the s 86 definition of settlor interested is very wide, so as to include spouse, children, grandchildren, etc.). However, s 86 is then disapplied if the trust has 'protected settlement' status (see the new insertion to Sch 5 below).

For trusts classed as protected trusts, s 86 continues to be 'switched off' for 'good' deemed doms (i.e. those that are deemed domiciled under the 15/20 year rule).

This is achieved by the insertion of a new para at TCGA 1992 Sch 5 para 5A. This is provided that 'no property or income is provided directly or indirectly for the purposes of the settlement by the settlor, or the trustees of any other settlement in which the settlor is a beneficiary or settlor' from the tax year in which he is deemed domiciled.

For those of us that remember the 'pre-March 1991 golden trusts', and the concept of tainting such a trust, these rules for not providing funds to the settlement after 6 April 2017 (or, if later, the start of the year in which the settlor becomes deemed domiciled) will be familiar. (This includes there being the ability to transact with the trust at arm's length, as well as some ability to meet shortfalls in trust income over expenses.)

However, the cost of this new legislation for protected settlements has been a very significant amendment to s 87. In effect, the s 87 pool can no longer be 'washed out' by capital payments to non-residents.

Furthermore, the settlor of an offshore trust will now be charged to capital gains tax under s 87 where a capital payment is made to a 'close member of the settlor's family', where the beneficiary is either:

- not resident in the UK; or
- was a UK resident non-dom claiming the remittance basis but not paying the RBC (i.e. because they have been here for less than seven years) and the gain paid to such a beneficiary is unremitted.

In such cases of attribution of the gain to the settlor, the settlor may reclaim the tax from the beneficiary or the trust without further tax consequences (although of course whether the settlor has a legal right to do so is another question!).

For this purpose, an individual will be a 'close member of the settlor's family' if that person is:

- the settlor's spouse or civil partner; or
- a child of the settlor, or of the settlor's spouse/civil partner, where the child has not reached the age of 18.
- (For this purpose, people living together as husband and wife or as same sex civil partners shall be treated as though they are husband and wife or civil partners.)

The amendments to s 87 then also go on to envisage the situation whereby a beneficiary ('the original beneficiary') who is not actually a 'close member of the settlor's family' receives a trust distribution, and then the original beneficiary makes an onward gift of that distribution within the next three years (or has already made a gift with the anticipation of receiving the distribution). In that case, in effect the original beneficiary is looked through and the provisions of s 87 operate as if the trust distribution were made directly to the person who receives the gift from the original beneficiary. Note that this anti-avoidance rule only applies if the original beneficiary is either non-resident or is a remittance basis user, plus the gain is not remitted.

Income tax rules

As yet the draft legislation for income within ITA 2007 s 720 or s 731 has not been published. The rules are widely expected to mirror those announced for capital gains as outlined above, but details will be released in due course.

What should we be doing now?

Now that we have some (relative) certainty over the government's plans for the non-dom changes, individuals who will become deemed domiciled on 6 April 2017 will want to ensure that their affairs are reviewed in good time. In particular, they may need to consider whether they should create an offshore trust while they still can.

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Trustees of offshore trusts will certainly also need to review the position for any trusts with s 87 gain pools, to consider whether any distributions should be made to non-resident beneficiaries pre-6 April 2017.

Going forward from 6 April 2017, there will be a planning window in relation to the rebasing possibility and also the ability to 'cleanse' mixed fund bank accounts that will most certainly be very welcome.

As ever, though practitioners will need to be mindful that the draft FB 2017 provisions are still very much that – draft provisions – and close attention will need to be paid as the draft makes its way through the legislative process. ■

For related reading visit www.taxjournal.com

- Autumn Statement 2016: A private client perspective (Wendy Walton, 24.11.16)
- The further consultation on non-dom reforms (Janet Paterson & Thomas Barker, 30.8.16)
- Q&A: Consultation on the reforms to non-domiciliaries (Arabella Murphy & Claire Roberts, 8.10.15)
- FA 2015: The new CGT regime for non-residents (Andrew Goldstone & Katherine Forster, 23.4.15)