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New UK non-dom tax changes in April 2017 – last chance to act

13 DECEMBER 2016

CATEGORY:
ARTICLE

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Following two formal consultations and much informal debate, we now have (most of) the much-anticipated legislation in respect of the changes to the taxation of non-UK domiciliaries. The government's response to the second consultation on these changes was published on 5 December 2016 and it is clear that the government has taken into account some of the key points brought up in the consultation process – the proposed changes to the taxation of trusts in particular has seen an about-face in approach. While we are still awaiting some further detail on certain points, it is clear that there will be no further movement on points of principle now, and therefore the following represents the likely final position:

TAXATION OF INDIVIDUALS

Probably two of the most helpful measures coming in as one time opportunities as part of the package of changes are cleansing and rebasing. These were confirmed and expanded in the draft legislation published on 5 December.

REBASING

This enables those who will become deemed domiciled under the 15/20 year rule test in April 2017 (see previous stop press) to elect which assets they wish to be rebased to their market value at that date, effectively wiping out any accumulated gain.

This is restricted in its application but is of potentially very significant benefit to those who are able to take advantage of it. There are four main conditions which must be met for it to apply:

*The assets were located outside the UK throughout the period from 16 March 2016 or, if later, the date the individual acquired the asset, to 5 April 2017;

- The assets were held directly by the individual on 5 April 2017;
- The individual paid the remittance basis charge in any tax year before the 2017/18 tax year; and
- The individual remains deemed domiciled under the 15/20 year rule at all times until the disposal of the assets.

These conditions mark a significant and helpful softening since the consultation document published in August, which indicated that only assets held directly outside the UK as at July 2015 would benefit from rebasing. The fact that assets held directly outside the UK between 16 March 2016 and 5 April 2017, as well as assets acquired up to 5 April 2017 are now included means that more assets will be able to benefit from this opportunity.

It also means non-doms who will become deemed domiciled in April 2017 should actively consider holding onto assets standing at a gain on 5 April to benefit from rebasing.

A meaningful and glaring omission from assets that can be rebased are assets that are subject to income tax on disposal. This means that, for example, interests in non-reporting status funds (such as hedge funds) cannot benefit from rebasing. People with significant hedge fund investments might want to consider redeeming or otherwise triggering a rebasing of the assets between now and April, if they will not benefit from the remittance basis after April.

CLEANSING OF MIXED BANK ACCOUNTS

Another helpful measure confirmed in the draft Finance Bill provisions is the cleansing opportunity. This effectively enables any non-dom who has been taxed on the remittance basis, and not just those who are subject to the new deemed domicile rules from April 2017, to segregate funds from within a mixed account. So, for example, an account containing a mixture of income, capital and gains can be separated out into its component parts, so that in future the most tax efficient parts can be remitted first.
It is important to note that cleansing only applies to cash.

There remains the question of how much detail will be needed in terms of records to determine the component parts of a mixed fund. The legislation is silent on this point and it therefore seems sensible to assume that any element of a mixed fund that can be identified can be segregated but that it will not be necessary to be able to identify every element of a mixed fund.

INDIVIDUALS- NEXT STEPS

Individuals should consider the following planning points before April 2017.

- Review which assets should be rebased – including potentially those standing at a loss as this can be set against onshore gains and remembering that assets that are rebased cannot also be contributed to trust;
- Liquidating structures such as companies in advance of April so that assets are held directly and can benefit from rebasing (of course other tax impacts should be considered);
- Redeeming or triggering a rebasing of non-reporting status fund investments;
- Collating records on mixed funds;
- Transferring assets e.g. between spouses offshore if one will benefit from rebasing and the other will not;
- Ensuring that if the remittance basis charge hasn't been paid in previous years it is paid for this tax year if that will enable someone to benefit from rebasing/cleansing – of course it will be necessary to balance the cost of the charge and the benefit of rebasing/cleansing;
- Consider holding assets until 6 April 2017 such that they are rebased and then selling them and cleansing the sale proceeds.

In all cases it will be important to ensure that tax and investment interests are aligned as closely as possible, and where, for example, there is an incentive to sell any asset or investment before April that would otherwise be rebased, both options are carefully considered.

TRUSTS- STILL AN EFFECTIVE SHELTER

One point of continuity since the changes were first announced has been that non-UK assets held in trusts settled by non-UK domiciliaries (who are not yet deemed domiciled) will continue to be treated preferentially for tax purposes.

Individuals who will become deemed domiciled from April 2017 will want to consider the creation (or further funding) of excluded property trusts, to protect non-UK assets from charges to inheritance tax and to permit the effective tax-free roll up of non-UK income and all gains. (A different treatment will apply to UK residential property – see previous stop press).

DISTRIBUTIONS

The treatment of distributions has improved from earlier proposals. One of the key concerns in the rules as they were presented in the August 2016 consultation paper was that making a distribution to the settlor or his family might 'taint' the trust for the life of the trust, thus losing the protected status mentioned above. It has been confirmed that this will not be the case, in fact:

- As currently, UK source income will be taxable on UK resident settlors of settlor interested trusts, regardless of their domicile status.
- The details of the rules relating to non-UK income are yet to be published, but it seems clear that non-UK income will not be taxed on the settlor on an arising basis even after the settlor becomes deemed domiciled (as long as he remains non-domiciled under the general law). Instead, the settlor will be subject to income tax on benefits received by himself or by a 'close family member' if they are not already taxable in that family member's hands. Close family members are the settlor's spouse or civil partner, cohabitee and minor children, but not adult children or minor grandchildren.
- Deemed domiciled settlors will also not be taxed to capital gains tax on an arising basis. Capital gains tax will instead be charged on the basis of the capital payments made from a trust, utilising the current 'matching rules' which match capital payments made to beneficiaries against any untaxed gains stockpiled in the trust.
- The general rules remain:

- If the beneficiary is UK resident and domiciled (or deemed domiciled), he will be subject to tax on the payment on an arising basis.

- If the beneficiary is UK resident but non-domiciled (and non-deemed domiciled), then he will be taxed according to his tax status – if he is a remittance basis user, there will be no tax unless the funds are remitted to the UK.

- If the beneficiary is non-UK resident then there will be no tax to pay (but see below for further details on capital payments made to non-residents).

- However, if the beneficiary is a 'close family member' of the settlor, then the settlor will be taxed on the capital payment in the cases mentioned above where the beneficiary is not taxed in that year – i.e. where the close family member is either non-resident or is a non-domiciled remittance basis user who does not remit the funds. This applies regardless of the domicile status of the settlor, albeit that non-domiciled remittance basis users will be taxed on that basis.

- To prevent avoidance, the Government is changing the way in which distributions to non-UK resident beneficiaries are treated – from April 2017, payments to non-residents will still not be subject to tax but they will not 'wash out' the stockpiled gains within the trust, meaning that trust gains will remain available to be matched against payments to UK resident beneficiaries in the future. The inability to wash out gains will apply to all offshore trusts whatever the residenc/domicile status of the settlor.

ADDITIONS

It is clear that if a settlor adds new funds to a trust once he has become deemed domiciled, the trust will no longer benefit from protected treatment, such that the settlor will be taxed on an arising basis on non-UK income and all gains realised by the trustees going forwards. The same is true if additions are made from another trust of which the settlor is either the settlor or a beneficiary, if the transfer is made after the settlor has become deemed domiciled. However, concern had been expressed that an addition to a trust by another person could also taint the trust – it is clear that this will not be the case.

The Government has confirmed that additions which are made to meet trust expenses relating to taxation or administration of the trust, which are not otherwise payable from trust income, will not taint the trust.

'RECYCLING' BENEFITS

The new 'close family member' rules could potentially have enabled avoidance by way of a distribution being made to a non-resident or remittance basis user who is not a close family member, who then gifts or lends the funds back to UK resident beneficiaries without triggering a charge to tax. In order to prevent avoidance by this channel, the Government will tax the UK resident recipient in respect of any funds received via this route within three years of the original distribution from the trust.

VALUATIONS

New statutory rules will also be introduced for valuing non-financial benefits received from all offshore trusts – for example, the use of chattels, property or interest-free loans. This will be based on the official rate of interest multiplied by the value of the asset in question, less any payments actually made by the recipient (rolled up interest will not decrease this annual charge).

TRUSTS- NEXT STEPS

- Existing trust structures should be reviewed to ensure that they will remain fit for their intended purposes following the introduction of the new rules.
- Non-domiciliaries should consider settling new trusts (or adding to existing trusts) before April 2017. Trusts settled before a person becomes deemed domiciled remain effective for inheritance tax protection (subject to the rules in relation to UK residential property). Since trusts will not lose their protected status except in so far as benefits are received, they also remain effective vehicles for income and capital gains tax purposes.
- Consideration should be given to washing out gains by making distributions to non-UK resident beneficiaries before 6 April 2017.
- Consider separating existing trusts before 6 April 2017 to create specific trusts for beneficiaries with different tax profiles or to hold specific classes of assets – for example, 'dry' trusts to hold non-financial assets – which will enable bespoke tax planning going forwards.
- Consider importing trusts to the UK where income and gains will be distributed: the inheritance tax shelter will remain provided the trust assets remain offshore.

To find out more and how we can help please contact one of the Withers team.

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