Domicile and Taxation

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Non doms – 2017 and 2018 changes

There have been a number of changes to the taxation of non doms in 2017 and 2018. Although the changes became final on 16 November 2017 most of their effects were backdated to 6 April 2017. This left non-doms in limbo in the intervening period, unsure what form the legislation would finally take, or even whether it would be enacted at all.

Broadly speaking, the changes made applicable from 6 April 2017 were as follows:

- Individuals who have been resident in the UK for at least 15 out of the last 20 tax years will be deemed to be domiciled in the UK for income tax, capital gains tax and inheritance tax.
- Individuals born in the UK with a UK domicile of origin will be treated as UK domiciled if they return to the UK after a period of residence abroad even if they had formed an intention to settle outside the UK in the intervening period.
- Non doms who became deemed domiciled on 6 April 2017 and had previously paid the remittance basis charge were given the opportunity to rebase foreign situs assets for capital gains tax purposes.
- Anyone who had previously claimed the remittance basis can cleanse their mixed funds, separating them into their constituent elements of income, capital and clean capital at any time before 6 April 2019.
- There were new rules relating to the taxation of offshore trusts which particularly affected settlor-interested trusts.
- Where a settlor-interested offshore trust is 'tainted' by an addition to the trust after the settlor became deemed domiciled the trust will become transparent for capital gains tax, and income tax purposes. It is therefore vital that offshore trusts which qualify for protected status are not tainted in this way.
- It should be noted that additions to a trust after the settlor became deemed domiciled under the old rules for inheritance tax would not have 'tainted' the trust under the old rules, but this would mean that the added funds were subject to inheritance tax in the trust. Inheritance tax charges would also arise on such additions. This remains the case for inheritance tax under the new rules albeit the test by which individuals become deemed UK domiciled has changed to 15 out of 20 years rather than 17 out of 20 years as was the case previously.
- UK residential property held through corporate, partnership or trust structures established by non doms will now be subject to inheritance tax

Further anti-avoidance provisions apply from 6 April 2018 in relation to offshore trusts.

These include anti-conduiting rules in relation to distributions made to beneficiaries and then passed on to other UK resident individuals, as well as the treatment of distributions made to non UK resident beneficiaries and how these affect the income tax and capital gains tax pools of offshore trusts.

Deemed Domicile – the new test

Prior to 6 April 2017, an individual's domicile status was determined under general law. This involved considering an individual's domicile of origin, which usually depended on the domicile status of their father, and then examining the pattern of their life [from birth onwards] to see if they had acquired a different domicile of choice which overrode their original domicile status.

A domicile of choice is acquired by settling in another jurisdiction with an intent to remain there permanently or indefinitely. Determining whether this had occurred involved reviewing an individual's pattern of life, often over many years, to determine their intent at particular points in time. For individuals with a domicile of origin outside the UK, the burden of showing that an individual was domiciled in the UK by choice falls on HMRC. Individuals intending not to remain in the UK could retain their non-UK domicile of origin and benefit from the remittance basis without time limit.

This was modified for inheritance tax purposes only, where an individual would be deemed to be UK domiciled if they had been resident in the UK for more than 16 out of the previous 20 tax years.

This has been replaced with a new test from 6 April 2017 which treats a non dom as deemed to be domiciled in the UK for all tax purposes after they have been resident in the UK for at least 15 out of the previous 20 tax years.

This 15 out of 20 year test, coupled with the introduction of the statutory residence test, means that the test for domicile for tax purposes is now simpler and more objective compared to the general law test, but at the cost of catching people in the UK tax net who have only a weak connection to the UK and who ultimately intend to leave the UK.

Returning UK Doms

As discussed above, an individual's domicile status at birth would usually be determined by that of their father. However, it would be possible for an individual born in the UK with a UK domicile of origin to acquire a domicile of choice outside the UK by taking up residence in another country with an intention to settle there permanently or indefinitely – a domicile of choice.

If an individual with a domicile of choice returned to the UK, but did not intend to settle in the UK permanently, they would retain their domicile of choice outside the UK and be entitled to claim the remittance basis. If they did intend to settle in the UK permanently, then their original domicile of origin would revive and they would be UK domiciled for tax purposes.

Under the new rules, someone born in the UK with a UK domicile of origin, would be treated as UK domiciled immediately on their return to the UK regardless of their intentions.

There is limited protection for inheritance tax purposes where someone returns to the UK for fewer than three years, so that any offshore trusts they have established when they were non doms would remain outside the scope of inheritance tax.

If such an individual breaks UK residence, they will be treated as not domiciled in the UK under the new rules for inheritance tax purposes once they have been resident outside the UK for three complete years.

Capital Gains Rebasing

The rebasing provisions apply to individuals who are non dom and became deemed dom on 6 April 2017. Returning UK doms are excluded from this relief. The individual must have paid the remittance basis charge at least once prior to 6 April 2017.

The relief applies to all personally non-UK assets held at 6 April 2017 provided the asset was not UK situate between 16 March 2016 (or acquisition if later) and 5 April 2017.

The rebasing is automatic, but can be disapplied on an asset by asset basis where this is beneficial, for example where the asset was standing at a loss over cost on 5 April 2017.

The effect of the rebasing is that, on a disposal after 5 April 2017, the base cost used to determine the capital gain will be the market value on that date.

If the asset was originally purchased out of clean capital, then on disposal there will be a capital gains tax charge on the rebased value, but the sale proceeds can be brought to the UK without additional tax charges.

However, care should be taken on the disposal of an asset where it was originally purchased out of anything other than clean capital, which is likely to be the more common scenario. The disposal proceeds will represent a mixed fund (see below) which will consist of the taxed capital gain, the rebased element, and the original purchase funds. A part remittance of the sale proceeds can be made without triggering additional tax charges provided the original purchase price remains outside the UK.

Cleansing Mixed Funds

A mixed fund is a bank account or other asset which represents a mixture of income, capital gains or non-taxable funds ('clean capital') and / or which relate to different tax years.

There are two rules which apply to transfers from mixed funds. The first rule applies when a remittance is made from a mixed fund, which sets out the order in which each component is treated as brought to the UK. Broadly, this would treat income of the tax year being treated as remitted in priority to capital gain, and then clean capital. Once those amounts have been exhausted, the balance of the remittance is treated as coming out of the prior tax year, and so on back in time. Income and capital gains that relate to periods prior to 6 April 2008 are subject to different rules.

The second rule applies where funds are transferred between offshore accounts rather than being remitted. These rules treat the transfer as taking a proportionate slice of all the types of income, capital gains and clean capital to the new account.

The interaction of these rules is complex and it can be difficult to track the movements of funds through several accounts.

HMRC have given individuals who have claimed the remittance basis, whether they paid the remittance basis charge or not, (i.e. not individuals who had been on the remittance basis automatically prior to 6 April 2008 but including those who were on the automatic remittance basis after that date) the ability to cleanse their mixed funds on offshore transfers made up to 5 April 2019. This only applies to cash, so other assets which represent mixed funds would have to be sold and held in cash form to take advantage of this relief.

The process sounds relatively simple to put into practice, but requires analysis of the history of a bank account to identify the constituent elements of a mixed fund. This could be difficult where there are incomplete records and / or many transactions over time.

The cleansing takes place by means of a transfer from the mixed fund to a new non-UK bank account, electing for a disregard of the offshore transfer rules. There is no prescribed form for the election, sometimes called a nomination, and it does not have to be sent to HMRC but kept as part of the individual's records in case there are queries at a later date.

This transfer is treated as taking a particular element of the mixed fund into a new account, as set out in the nomination.

Unfortunately, the nomination can only apply to one transfer per bank account although multiple transfers by funneling amounts through successive bank accounts are possible, provided banks co-operate with these arrangements. It is therefore important to make transfers in the right order.

It is anticipated that it will be possible to cleanse mixed funds where only one element of the funds can be identified e.g. a large capital gain made in one year, rather than having to identify the composition of the whole fund which would be both difficult (if not impossible) and cost prohibitive.

Some guidance from HMRC has been published but some clarification on this from HMRC is awaited.

Offshore Trusts

For UK domiciled settlors, an offshore trust is transparent for income tax, capital gains tax and inheritance tax where they retain the ability to benefit from the trust.

This treatment does not apply to non doms who can benefit from an offshore trust unless they 'taint' the trust after the later of 6 April 2017 or the date on which they become deemed domiciled. Instead, with the exception of UK source income received within the trust, only benefits conferred on the settlor and / or beneficiaries will be taxable on them when matched to foreign income and then capital gains arising in the trust.

This broadly aligns to the existing tax treatment of non-settlor interested offshore trusts established by a non dom.

Benefits conferred on non doms who are deemed to be domiciled in the UK will be taxable wherever in the world they are provided. Benefits conferred on non doms who are not deemed domiciled and who claim the remittance basis will only be taxable if brought to the UK. Such benefits could be taxable on the settlor in some circumstances.

Tainting

As discussed above, this beneficial tax treatment of an offshore trust will only continue whilst it is not tainted by additions of funds or other value after 6 April 2017.

Tainting includes both the direction addition of funds, a transfer from another trust from which the settlor can benefit, and loans made to the trustees other than those made on qualifying terms. It is possible to make additions to the trust to meet some fees where the trust cannot meet them out of income.

It is therefore vital that any transaction that involves additions to trusts should be carefully considered and professional advice taken.

UK residential property held through offshore structures.

A UK domiciled individual is subject to UK inheritance tax on their worldwide assets. A non UK domiciled individual (and one not deemed to be domiciled in the UK) is taxable on their UK assets only.

UK residential property is clearly a UK situs asset. However, prior to 6 April 2017,when such property was held through an offshore entity such as a non UK company, this would 'mask' the UK asset so that the property would be outside the scope of UK inheritance tax. Such offshore holding structures were referred to as excluded property.

Under the new rules, non UK entities will no longer be excluded property to the extent that their value derives from UK residential property. UK commercial property is not, as yet, caught by these rules.

So, if a non UK company is worth £5 million and its entire value is derived from UK residential property, then the whole value will be within the scope of inheritance tax. If the company derives half of its value from UK residential property, then £2.5 million will be within the scope of inheritance tax. This lookthrough extends to chains of entities, so that inserting intermediate holding companies will not prevent this treatment from applying.

There is a de minimis limit where UK residential property is disregarded if its value in relation to the value of the whole entity is less than 5%.

Loans to acquire UK property, whether charged on the property or not, are treated as UK residential property under these rules. However, such loans are allowed as a deduction against the value of the property for inheritance tax purposes where this is appropriate under the usual rules e.g. where it is charged on the property.

However, it is possible for the debt to not be deductible (because it is not charged on the property) against the value of the property for the borrower but still to be treated as residential property for the lender so that double inheritance tax charges can arise. Advice in relation to such arrangements is therefore recommended.

Inheritance tax charges can now arise where UK residential property:

- is held by a non dom on death;
- is transferred to another person by a non dom and they do not survive seven years from the date of the gift;
- is transferred into a trust, with additional charges if the non-dom does not survive seven years from the date of the transfer;
- on each ten year anniversary of the creation of a discretionary trust at rates up to 6% of the value of the property on the anniversary date;
- where the property is transferred out of a discretionary trust;
- where the settlor retains a benefit in the residential property

As the new rules only apply from 6 April 2017, the first ten year anniversary of a trust directly or indirectly holding UK residential property that falls after this date, will see the charge pro-rated between chargeable and non chargeable periods.

Overall, then, the new rules are complex both in respect of tainting and UK residential property. Great care is needed to ensure that a protected trust does not become tainted because of the onerous consequences of doing so and advice should always be taken before trust related transactions involving the settlor are considered. However, opportunities exist to benefit from both rebasing and cleansing relief, provided matters are well planned.

In addition, the residential property rules have a much greater reach than simply UK residential property held through an offshore company. Any trustee that has made loans to a beneficiary will need to consider carefully whether these have been applied in purchasing or enhancing UK property. Trust structures holding property for development or letting purposes will also need advice. Please speak to your normal Moore Stephens contact if you have queries about any of the issues raised in this note.

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