Reforms to the taxation of non-domiciled individuals

In August 2016, the government released a further consultation paper regarding the proposed reforms to the taxation of non-domiciles. This follows on from the Summer Budget of 8 July 2015 which proposed that all individuals resident in the UK for more than 15 years should pay UK tax on their worldwide income and gains in the same way as those individuals domiciled in the UK. It had been thought that the government might not press ahead with these reforms in the light of the EU referendum result, but the consultation paper confirms that the reforms are intended to take effect as planned from the start of the next tax year, 6 April 2017. The consultation paper provides further detail, and is accompanied by draft legislation.

Deemed domicile

The paper confirms that those who have been resident in the UK for 15 out of the previous 20 tax years will be treated as deemed domiciled in the UK for income and capital gains tax purposes. Such persons will, from April 2017, no longer, for example, be able to claim the remittance basis of taxation from the beginning of their 16th year of residence in the UK. As per current legislation, a split year is taken into account for the purposes of this test, so that it is possible to become deemed domiciled after little more than 13 calendar years of residence.

Currently, for inheritance tax, a person is considered deemed domiciled from the start of the 17th year of tax residence within the last 20 years. These changes bring that forward to the start of the 16th year of residence within that period. Once a person becomes deemed domiciled then, for inheritance tax purposes, his worldwide assets, not just his UK assets, will be within the scope of inheritance tax.

The deemed domicile status will also be difficult to shake off, as, for income tax and capital gains tax purposes, an individual will have to become non-UK resident and spend at least six tax years as a resident outside the UK in order to lose their deemed domicile status.

This is to be contrasted with the position for inheritance tax. The government did not intend to create a six year ‘shadow’ for inheritance tax, so, for inheritance tax purposes only, deemed domicile status will be lost after four consecutive tax years of non-residence.

The current rules will apply to those who leave the UK before the new rules come into effect but who would otherwise be treated as deemed domiciled under the 15/20 year rule.

In addition, those born in the UK with a domicile of origin within the UK will always be treated as deemed domiciled in the UK for any period that they are resident in the UK, even if they have acquired a domicile of choice elsewhere. The government does however intend to introduce a short grace period for inheritance tax purposes only, so that such persons will not become deemed domiciled for inheritance tax purposes unless they have been resident for one of the two tax years prior to the year in question. This will prevent such persons

becoming subject to inheritance tax on their worldwide assets should they die on a brief return to the UK, but will not allow them to take advantage of the remittance basis of taxation.

Rebasing

It is important to note that those individuals who become deemed domiciled for the first time on 6 April 2017 as a result of the above new provisions will be able to rebase their non-UK assets to their market value on 5 April 2017. The rebasing will apply to those assets which were foreign situs assets at 8 July 2015, the date of the Summer Budget. It will also be restricted to those who had paid the remittance basis charge in any year before April 2017.

Trusts

There has been a change in the proposed taxation of trusts established by non-doms. Currently the remittance basis protects non-domiciled settlors from liability to income and capital gains tax on foreign source income and gains arising in a non-resident trust. Should they become deemed domiciled however, such protection would no longer be available and such settlors would become taxable on all income and gains of the trust. The government had previously confirmed it would not seek to tax settlors who become deemed domiciled under the new rules on undistributed trust income and gains of trusts set up before they became deemed domiciled under the new 15/20 year test. The government had proposed to base the new rules on the taxable value of benefits received by the deemed domiciled individual without reference to the income and gains arising in the trust.

It is now proposed that such trusts are given protected status, so that they are protected from the impact of the settlor becoming deemed domiciled unless they are used to benefit the deemed domiciled settlor (or their spouse or minor children or stepchildren). From that point onwards, the trust will cease to be protected and the settlor may suffer tax on the income and gains. The protection will also be lost if any funds are added to the trust by the settlor while he is deemed domiciled.

However, it is understood that negotiations are ongoing between HMRC and interested parties as to whether the proposed changes are the best way to implement the intended protection. The proposals may therefore be the subject of further revision prior to April 2017 and should not be treated as final.

The government intends that any trusts established by an individual with a UK domicile of origin who returns to the UK be treated in the same way as a trust that was set up while they were UK domiciled, for any period they are resident in the UK. This would have the effect of making income and capital gains in the trust taxable on the deemed dom as they arise, while the individual is resident in the UK. The trust will also be chargeable to inheritance tax while the individual is resident in the UK, but this will be with the benefit of the grace period.

Inheritance tax on UK residential property

Another significant proposal had been to ensure that all UK residential property would be within the scope of inheritance tax, even if held within a structure. It is currently possible for non-domiciled individuals to shield such property from inheritance tax by having the property owned by an offshore company, for example.

This proposal remains and will be achieved by an amendment to the existing legislation to remove UK residential properties owned indirectly through offshore structures from the current definitions of "excluded property". This will make such property liable to all inheritance tax events, so not only on death, but also on gifts and ten-year anniversaries of trusts, for example.

The precise definition of "residential property" has not been finalised, but the government proposes to use the same definition as for non-resident capital gains tax. Debts that relate exclusively to the property will be deductible, although there are restrictions for loans between connected parties.

Transitional arrangements

In recognition of the fact that these changes would be likely to cause many people to want to collapse their structures, the government had indicated that it might make temporary adjustments to tax legislation to facilitate any "de-enveloping". Unfortunately the government has now confirmed that no such adjustments will be made.

Summary

The reforms are drastic, particularly in the realm of income and capital gains tax. Those who had been adopting a 'wait and see' approach now face a relatively short time-frame to undertake any restructuring. It is important that any persons affected by the proposed changes review their situation in good time before April 2017. Unfortunately the fact that the tax proposals in relation to trusts appear not to be finalised, makes this very difficult, and it is to be hoped that the government will clarify the position as soon as possible.

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