BRIEFING NOTE

October 2016

ROOKS RIDER SOLICITORS

Reform of the Taxation of Non-UK Domiciliaries

Announcements made at the Summer Budget on 8th July 2015 suggested an end to the favourable UK tax rules relating to non-UK domiciliaries, and new rules that would mean individuals resident in the UK for more than 15 years would have to pay UK tax on their worldwide income and gains in the same way as an individual who is domiciled in the UK. Following an extended period of consultation, more details and draft legislation have now been published with a view to the new rules taking effect in April 2017.

Changes include:

1. A new concept of deemed UK domicile which applies to all UK direct taxes;

2. Changing the treatment of offshore structures such as trusts settled by deemed UK domiciliaries and non-resident companies;

3. People who were born in the UK with a UK domicile of origin and who acquired a non-UK domicile after leaving the UK will be treated as UK domiciled if they return to the UK (see our Briefing Note: "*A New Deemed Domicile Rule for formerly Domiciled UK Residents – Returning Ex Pats*"); and

4. Subjecting UK residential property to Inheritance Tax ('IHT') where it is held through non-UK structures (see our Briefing Note: "*IHT: UK Residential Property held through Non-Resident Trust Structures*" for details).

Deemed UK Domicile: The Fifteen Year Rule

At present domicile for Income Tax and Capital Gains Tax **('**CGT'**)** is decided according to general principles of law, with the rule that makes an individual deemed domiciled for IHT purposes only when they have been resident in the UK for 17 out of the previous 20 tax years. A non-UK domiciliary can claim the remittance basis which means they are taxed on foreign income and capital gains only if they are brought to or enjoyed in the UK. Individuals who have been resident in the UK for more than 7 out of 9 of the previous tax years have to pay a Remittance Basis Charge ('RBC') to claim this treatment at a rate that depends on length of residence in the UK.

From 6th April 2017, a new deemed domicile status will apply to an individual who has been resident in the UK for at least 15 out of 20 of the previous tax years. This will apply to Income Tax, CGT and IHT and years of residence as a child will count towards this total.

Residence for any particular year will be determined according to the tests that applied at the time, i.e the Statutory Residence Test for periods after 6th April 2013, and the non-statutory rules that applied before that date.

For Income Tax and CGT purposes, it is possible to split tax years into a resident and non-UK resident portion where someone leaves or comes to the UK part way through the year. The split year treatment will not apply when determining domicile status so a year of departure or arrival will count towards the 15 year test.

A deemed domiciliary will not be entitled to claim the remittance basis and will be taxed on worldwide income and capital gains. They will also be taxed to IHT on their worldwide estate on death. Offshore trusts established by individuals before they become deemed domiciled will continue to provide protection for IHT (except in relation to UK residential property) and, subject to certain conditions, will provide protection for CGT and Income Tax in relation to non-UK source income (see our Briefing Note: "*Changes to the Taxation of Non-UK Trusts*"). Unfortunately these protections will not be available for individuals who become deemed domiciled because they were born in the UK with a UK Domicile of origin and are resident in the UK (see our Briefing Note: "*A New Deemed Domicile Rule for formerly Domiciled UK Residents – Returning Ex Pats*").

Breaking Deemed Domicile

An individual will have to cease UK residence for six complete tax years if they do not wish to satisfy the 15 out of 20 year test on their return to the UK. Once an individual has ceased to be UK resident, their liability to income is limited to UK source income and CGT is restricted to some limited categories of UK assets including UK residential property, so the delay in losing domicile status is manageable from an Income Tax and CGT point of view. Being UK deemed domiciled after breaking residence does affect the IHT position however as an individual would remain liable to IHT on the worldwide assets after ceasing to be resident.

The current proposal is that an individual would no longer be deemed domiciled for IHT purposes once they had ceased to be UK resident for four complete tax years.

If an individual returns to the UK after four years, however the 15 out of 20 year deemed domicile test will apply again for all taxes. If not, an individual could leave the UK for four years to break their IHT deemed domicile but would be deemed domiciled for income tax and capital gains tax after they return.

An Individual leaving before 6th April 2017

There was some confusion as to which rules would apply to someone leaving before 6th April 2017 and whether they would have to complete 6 years of non-UK residency to cease being deemed domicile rather than the four years that applied under the old rules. As these rules are now consistent for IHT, this is no longer an issue for permanent leavers.

There are transitional rules to protect individuals who left the UK and ceased to be deemed domiciled under the old rules, made gifts, and then returned to the UK who would be treated as deemed domiciled under the new rules. These gifts will remain outside the scope of IHT.

Rebasing Foreign Assets for CGT purposes

Where an individual becomes deemed domiciled at 6th April 2017, they will be able (although not compelled) to rebase foreign assets to the then market value provided they held the asset and it qualified as a foreign asset on 8th July 2015. The individual must have paid the RBC at least once. This rebasing will be on an asset by asset basis and means that only increases in value from 6th April 2017 will be brought into the charge to CGT on a later disposal.

This rebasing will only apply to directly held assets, so it will not extend to assets held through trust and/or company structures. Individuals who become deemed domiciled at a day later than 6th April 2017 will not be able to claim this relief.

If the funds used to acquire the asset were clean capital then the whole of the proceeds of sale can be brought into the UK without additional tax charges. However, if the acquisition was made using funds taxable on the remittance basis, when the asset is sold, the proceeds will represent both post-April 2017 Capital Gain already taxable on the arising basis, the pre-2017 gain element (which can be brought to the UK without additional tax charges) and the acquisition costs which could be taxable if remitted. It should be possible to mitigate the remittance exposure by only bringing part of the proceeds of the sale to the UK but this will require careful management (see below – "*Mixed Funds*").

It should be noted that the consultation document only refers to assets falling within the scope of CGT. The gains on certain offshore funds are calculated according to CGT rules but liable to income tax. It is hoped that the rebasing will extend to such assets but that is not expressly stated.

Mixed Funds

There will be a one year window during the tax year, 6th April 2017 to 5th April 2018 during which non-UK domiciliaries will be given the chance to rearrange their mixed funds. These are funds which hold a mixture of income and/or capital gains and clean capital, sometimes from different years which are subject to complex rules which determine what element is treated as remitted first.

This opportunity will be available to any non-domiciliary who was not born in the UK with a UK domicile of origin, and is not restricted to individuals becoming deemed domicile on 6th April 2017.

This provision will only apply to bank accounts holding cash (or similar), rather than assets but it will be possible to sell assets and convert them to cash to take advantage of the relief. We do not have the details of how this measure will work in practice, but the consultation document indicates that the effect will be that a mixed fund will be separated into its constituent elements which can be held in different bank accounts. The individual will then be able to choose which bank account they remit from and be able to choose the funds which will attract the lowest rate of taxation in priority to funds which would attract a higher rate.

This is likely to be very attractive to any non-domiciliary who holds mixed funds as it may give them a one-off opportunity to access clean capital or capital gains (which are subject to lower rates of tax).

Capital Loss Election

Prior to 2008, a non-domiciliary could not claim losses on their foreign assets. After that date they could do so provided they made an election. The election was irrevocable and once it was made, a special order applied to set off UK and foreign losses that was not always advantageous. If the election was not made, an individual would not be able to claim foreign losses even if they later ceased to claim the remittance basis. The ability to claim losses would only revive if the non-domiciliary became domiciled in the UK.

It is proposed that the capital loss election will continue to work in the same way after 6th April 2017, but it will only apply to the period until an individual becomes deemed domiciled or actually domiciled in the UK. At that point, they will be allowed to claim foreign losses in the usual way. In their non-domiciliary period, if they have not made an election they will not be able to claim foreign losses.

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For further information on any of the issues raised in this Briefing Note, please contact a member of the Rooks Rider Solicitors Wealth Planning Team.

Karen Methold
Partner
Head of Wealth Planning
+44 (0)20 7689 7112
kmethold@rooksrider.co.uk

Christopher Cooke
Senior Partner
Corporate & Wealth Planning
+44 (0)20 7689 7110
ccooke@rooksrider.co.uk

Robert Drysdale
Associate
Wealth Planning
+44 (0)20 7689 7168
rdrysdale@rooksrider.co.uk

Nicholas Jenkins
Managing Partner
Wealth Planning
+44 (0)20 7689 7161
njenkins@rooksrider.co.uk

CREaTe

Rooks Rider Solicitors LLP
Challoner House
19 Clerkenwell Close ■ London ■ EC1R 0RR