



## Reforms To The Taxation Of Foreign Domiciliaries

### Overview

In the Summer Budget 2015, George Osborne, the Chancellor at that time, proposed a series of changes to the regime for the taxation of foreign domiciliaries resident in the UK. These amounted to a sea change, and came as a surprise. The Government realised that and to allow those affected time to make proper arrangements announced that the measures would become effective from **6 April 2017**, with time for consultation on the details.

The main changes can be summarised as follows:

- A. Anyone born in the UK with a UK domicile of origin (defined as a “Formerly Domiciled Resident” or “FDR”) who is UK resident in a tax year will be deemed domiciled in the UK for all tax purposes (subject to a period of grace for Inheritance Tax (IHT) if the individual was not UK resident in either of the preceding two tax years);
- B. A long term resident – one who has been UK resident in at least 15 of the immediately preceding 20 tax years – will be deemed domiciled for all tax purposes;
- C. The scope of IHT will be extended so as to apply to:
  - UK residential property owned by foreign domiciliaries (or trusts settled by foreign domiciliaries) through a foreign company or partnership;
  - relevant loans (broadly a loan where the funds are used for the acquisition, maintenance or enhancement of an interest in UK residential property); and
  - collateral on the relevant loan.

The deemed domicile provisions (A and B) apply for tax purposes only and will not affect an individual’s domicile under general principles. Furthermore, the circumstances of parents will not impact on their children, whose status will be tested separately by reference to their own fact patterns.

Since the Summer Budget 2015 there have been various meetings between HM Treasury/HMRC and stakeholders. An initial Consultation Document on the deemed domicile proposals was released in September 2015. Apart from a brief mention in Budget 2016 (when some transitional provisions for long-term residents were announced) we then had to wait until August 2016 for a further document. This was a hybrid Response and Consultation Document with the consultation period ending in October 2016. A further Response document was published on 5 December 2016, with some draft legislation also being published on that day as part of the general publication of draft clauses for Finance Bill 2017.

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Whilst there was no public announcement of an extension to the scope of the changes, the Response Document and draft legislation include reforms to the non-resident trust anti-avoidance provisions that will affect more than just those becoming deemed domiciled on 6 April 2017. These changes are discussed in section C.

In addition it should be noted that the current draft Finance Bill 2017 clauses extending the disguised remuneration provisions appear to be so wide as to apply to private trusts with underlying companies. It is hoped that amendments will be made to restrict the scope of the clauses prior to the actual Finance Bill 2017 being published in March/April 2017.

This briefing sets out the proposals as we understand them as at 31 December 2016.

As we are still awaiting further draft legislation (which will then have to pass through the Parliamentary process), this is unlikely to be the final position. There are areas where the draft legislation is not clear and/or disagrees with the comments in the December Response document, and we have highlighted areas where this is the case below. We have also highlighted the changes between the documents released in August 2016 and the position now reflected in the December documentation.

## A. Individuals Born in the UK with a UK Domicile of Origin

### 1. Income Tax and Capital Gains Tax ("CGT")

From 6 April 2017, UK residents who were born in the UK with a UK domicile of origin ("FDRs"), but who have subsequently acquired a foreign domicile by choice (or possibly dependency), will not be able to access the Remittance Basis.

For Income Tax and CGT purposes such individuals will, when UK resident, be taxed in the same way as anyone domiciled and resident here – i.e. on worldwide income and gains (the 'Arising Basis').

They will remain taxable on any Remittance Basis income and gains from prior years remitted after 5 April 2017, as at present, unless aided by narrow transitional provisions.

In addition the non-resident trust and company anti-avoidance provisions for Income Tax and CGT anti-avoidance codes will apply to the income and gains of foreign trusts and companies in exactly the same way as they do for anyone resident and domiciled here. Those affected will therefore:

- have the income and gains of non-resident trusts of which they are settlors, and certain foreign companies, attributed to them on the Arising Basis; and

- no longer benefit from the transitional CGT reliefs for foreign domiciled beneficiaries of non-resident trusts (the so called "rebasement election" and exemptions for unmatched capital payments made or gains realised pre 6 April 2008) introduced in Finance Act 2008.

Non-resident trustees will find themselves having to provide UK tax reporting information on foreign income and gains which hitherto has not been required. In some cases they may not have UK advisers but will need to take advice to understand the implications of the changes on the reporting requirements for the settlor and beneficiaries. Matters may be further complicated if the settlor moves in and out of UK residence.

### 2. IHT

FDRs will also be subject to IHT as if domiciled. Furthermore, any trust of which a FDR is a settlor will be denied "excluded property status" for as long as the settlor remains resident. There is one softening measure. This is referred to as the "grace period" and it means that the IHT provisions set down below will only apply where the individual:

- is UK resident in the relevant tax year; and
- was also UK resident in at least one of the two preceding UK tax years.

It is because there can potentially be such a severe impact on otherwise excluded property trusts that the Government is prepared to allow what is effectively a one year grace period.

Where the settlor can benefit, anti-avoidance legislation will also apply to all trust property, UK or foreign, which may be subject to the "Gift with Reservation of Benefit" provisions, with the result that the property is deemed to remain within the settlor's estate on death, as well as being subject to periodic and exit charges under the relevant property provisions. Alternatively, the Income Tax charge on Pre-owned assets could apply.

The Government has rejected calls for "grandfathering" provisions for existing trusts established before the announcement of these proposals on 8 July 2015. The transitional provisions for settlements made before 10 December 1974 are retained.

When determining the periodic charge under the new legislation, the general IHT rules will still apply. This means that if the settlor is deemed domiciled for IHT purposes at the time of a ten year anniversary, the decennial charge will be calculated taking the cumulative number of quarters in which he has been deemed domiciled for IHT as a fraction of the forty total quarters in the ten year period.

### 3. Leaving the UK

From an Income Tax and CGT perspective, domicile is irrelevant for non-residents (only coming into play in



the tax year of return if the individual returns soon enough to engage the provisions relating to temporary non-UK residence).

Domicile does, however, continue to be important for IHT purposes for certain non-residents who have been domiciled in the UK, or who have been deemed domiciled here under either the new rules applying to FDRs or those deemed domiciled by virtue of long term residence.

A FDR will lose his deemed domiciled status in the first full year of non-residence, provided that:

- he retains a foreign domicile under general principles; and
- has not become deemed domiciled by virtue of long term residence.

Where an individual deemed domiciled as a long-term resident ceases to be UK resident;

- he would cease to be a FDR (if he had that status) at the start of the first full tax year of non-residence, so that trusts which had lost excluded property status by virtue of his UK residence would at that point have their exempt status restored;
- he would continue to be deemed domiciled for IHT purposes with regard to his personal estate until the start of the fourth year of non-UK residence (that is three complete tax years of non-UK residence are necessary and the individual cannot resume UK residence in the fourth tax year).

#### 4. History can never be changed!

As both a person's place of birth and domicile of origin are unalterable facts, anyone born in the UK with a UK domicile of origin will always be a FDR if he re-establishes residence in the UK, no matter how many years he might have spent abroad, and regardless of whether he has acquired a domicile of choice elsewhere. The example below illustrates how the rules can apply:

*James was born in London. His parents were married and his father had a domicile of origin in England and Wales. The family left the UK and settled permanently in New Zealand when James was three. His father established a domicile of choice there giving James a domicile of dependency in New Zealand. He has retained this domicile (by choice) into adulthood, becoming successful, and wealthy. For local estate planning reasons he settled substantial funds onto trusts for his family. On 24 July 2017 (when he was 45) his firm asked James to accept a three-year posting to the UK to take the lead on a special project.*

*Despite his having lost all his connections with the UK, the new provisions would mean that if James accepts the posting, he would be a FDR on arrival, and denied the benefits of his foreign domicile of choice. He would be taxed in exactly the same way*

*as a UK resident UK domiciled individual on worldwide income and gains. From the start of the second year of UK residence (on expiry of the IHT grace period) his worldwide assets, including the assets in all the trusts he has settled, would fall into the IHT regime throughout the remainder of his UK residency.*

*The tax implications, particularly the IHT exposure for the funds on the family trusts, may be sufficiently serious for James to decide to decline the posting to the UK. (NB the effects of Double Taxation Agreements may mitigate the problem in certain cases).*

## B. Long-Term UK Residents

### 5. Introduction

From 6 April 2017, foreign domiciliaries who have been UK resident for at least 15 of the immediately preceding 20 tax years will be deemed UK domiciled for all tax purposes. Such individuals are referred to as 'long-term UK residents'. There is one transitional exception to this rule where:

- 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 individual was UK resident.

Since non-residents will not need to make Remittance Basis claims this exception will generally be of use for IHT purposes only.

For a person continuously UK resident, deemed domicile will therefore commence from the 16th tax year of residence. Individuals who have been continuously UK resident since 2002/03 or earlier will, unless they cease to be resident in the current 2016/17 tax year, become deemed domiciled from 6 April 2017.

Although the draft legislation provides a get out for those who would have been caught by the reduction of the residence period to 15 years but for having left the UK before 6 April 2017, there is no more general provision that would exempt a person who leaves after 15 years of residence from being treated as deemed domiciled for the first time in the 16th year, when no longer resident in the UK at all – and for the following 3 years (the deemed domicile tail for IHT then being lost provided he remains non resident in the 4th tax year). It is hoped that an amendment will be made to reflect the announced intent that an individual could remain in the UK for 15 years without being subject to IHT on a worldwide basis in subsequent years when the individual is not resident. For Income Tax and CGT a non residence period of six tax years is required for the Remittance Basis to be claimable on any return to the UK.



Residence for the purposes of the long-term resident test is determined in accordance with the law which applied for the tax year in question. The Statutory Residence Test is therefore only applied for tax years from 2013/14 onwards. All years of UK residence will count, including years in which the individual was only resident for part of the year, and years in which the individual was a minor.

A non-domiciled individual who has less than £2,000 of unremitted foreign income and gains in a tax year is presently allowed automatic access to the Remittance Basis without loss of allowances or liability to the Remittance Basis Charge. In the August Consultation Document it was confirmed that this will continue to apply even when the individual has been resident for more than 15 years. This decision is entirely pragmatic since the tax at stake is relatively small compared to the cost of collection.

The existing Remittance Basis Charges for those who have been resident in the UK for 7 of the previous 9 tax years (£30,000), and 12 of the previous 14 tax years (£60,000) will remain in place. The £90,000 Remittance Basis Charge (which took effect from 6 April 2015 for individuals who have been resident for 17 of the previous 20 years) will become obsolete from 6 April 2017 since all individuals who have been resident for that length of time will be deemed domiciled.

An individual could be deemed domiciled both as a FDR and as a long-term resident. Where the conditions for both are satisfied, the less favourable provisions for FDRs (which offer no transitional relief and no protection for trusts) will take precedence.

The position for FDRs has been described in section A. This section B will focus only on the position for foreign domiciliaries who are long-term UK residents.

## 6. Income Tax and CGT

A foreign domiciled UK resident will become deemed domiciled (and so subject to UK tax on worldwide income and gains) from the start of the tax year in which he has been UK resident in 15 of the immediately preceding 20 tax years. He will remain taxable on any Remittance Basis income and gains from prior years remitted after becoming deemed domiciled (subject to narrow transitional reliefs described below).

This change has required consideration as to the way in which relief will be given for capital losses. Presently, a foreign domiciled UK resident who makes a claim to access the Remittance Basis can choose either to forfeit entitlement to relief for foreign capital losses (being able to claim relief only for UK losses) or make a Capital Loss Election. The Election has to be made irrevocably and within strict time limits. Making the Election entitles the individual to relief for all his capital losses, subject to provisions dictating the order of offset against remitted and unremitted foreign gains and UK gains (in a generally

unfavourable way). To adapt these provisions so that they operate effectively under the new regime, the following changes are proposed:

- When an individual becomes deemed domiciled and liable to pay CGT on worldwide capital gains, he will be treated in the same way as a UK resident and domiciled person from that year onwards and be able to set off capital losses against capital gains, without distinction between UK and foreign gains and losses.
- If the individual later loses his deemed domicile (through an extended 6 year period of non-residence) and returns to the UK, able once again to access the Remittance Basis, he will have the option to make the Capital Loss Election afresh. Any previous decision to elect or not made in the earlier period of residence is irrelevant.

The introduction of deemed domicile for all tax purposes is a material change and, to soften the effects, George Osborne announced in Summer Budget 2015 that there would be provisions to protect settlors of foreign trusts from taxation on undistributed income and gains arising after they had become deemed domiciled under these provisions.

What exactly these favourable rules should be has been the topic of controversy. The current proposals (explained in section B4) are different from the August 2016 proposals and significantly different from the September 2015 proposals.

In addition to the provisions implementing some “protection of non-UK resident trusts”, the Government has taken the opportunity to introduce significant changes to the anti-avoidance provisions relating to offshore trusts generally. **These changes go beyond what was announced at Summer Budget 2015.** Broadly:

- new rules are to be introduced in connection with the valuation of non monetary benefits and capital payments;
- for Income Tax purposes the changes apply to all settlors of non-UK resident trusts who retain a foreign domicile under general law, except for FDRs. There are no changes to the income tax provisions that apply to UK domiciled settlors and FDRs are taxed as if they were UK domiciled settlors for CGT purposes, some of the changes apply regardless of domicile status or whether the benefit is received by the settlor or another beneficiary.

See section C for further detail.

## 7. Inheritance Tax

Once a foreign domiciliary has become deemed domiciled as a long-term UK resident, his worldwide assets, not just his UK assets, will be potentially within charge to IHT.

Any transfers of value made by such an individual will be governed by the same rules which apply to UK



domiciliaries. For example:

- A gift to a child, whether of UK or foreign assets, would be a Potentially Exempt Transfer (PET). The PET would fail and IHT may be payable if the deemed domiciled donor dies within 7 years of making the PET.
- A transfer by a deemed domiciled individual to a trust (whether resident or non-resident) would be a chargeable lifetime transfer with an immediate charge to tax (around 20% depending on the availability of the nil-rate band etc.), with the potential for an additional liability if the settlor dies within 5 years of the transfer. The trust property would be within the relevant property regime and, if the settlor is able to benefit under the terms of the trust, the assets will remain deemed to be part of his estate on death under the Gift with Reservation of Benefit provisions.

## 8. Transitional provisions

### Income tax and CGT

A number of transitional provisions are to be introduced for foreign domiciled long-term UK residents. In the case of some provisions the criteria are narrow, but where they apply, they will be helpful (some surprisingly so). However, the provisions are complex and specialist advice should be taken.

### CGT Rebasing Relief

Individuals becoming deemed domiciled as long-term residents at the inception of these rules (ie on 6 April 2017), will be able to calculate gains subject to CGT on foreign assets held by reference to the value of the asset as at 5 April 2017.

The proposed rebasing relief could be very valuable to those who meet the requisite conditions. For the individual to benefit:

- he must not have been born in the UK with a UK domicile of origin (an FDR);
- he must not be domiciled in the UK under general principles at any time during the year that the asset is disposed of;
- he must have held the asset at 5 April 2017, with the disposal taking place after that date;
- the asset must have been foreign situs throughout the period from 16 March 2016 (or if acquired later, the date of acquisition) to 5 April 2017. The asset is not regarded as situated in the UK where it has been brought to the UK and on remittance and throughout the period to 5 April 2007 one of the remittance exemptions (Business Investment Relief not counting as it is a claimable relief rather than an exemption) applies – so those for personal use, public access, repairs, temporary importation and notional remitted amount. Rebasing can still apply to these assets if all the other conditions are met;

- he will have to be in the first wave of those acquiring deemed domicile on 6 April 2017, (in effect therefore restricting access to the relief to individuals who have been UK resident in at least 15 out of 20 of the UK tax years 1997/98 to 2016/17, and remain UK resident in 2017/18); and
- must have paid the Remittance Basis Charge at least once prior to 6 April 2017 (so minors will not be able to benefit even if all the above conditions are met).

For the purposes of the above provision, where there is a re-organisation, and no consideration given or received by the individual, the new holding will generally be equated with the original shares. For relief to apply both the original holding and the new holding must be foreign situs from the later of 16 March 2016 and acquisition to 5 April 2017.

The relief will only be available in respect of assets held directly by the individual. Despite representations, there is to be no rebasing for assets within trusts or for those held within companies. In addition (and controversially) the Government has stated that it is not minded to allow relief for non-reporting funds (though the way the draft legislation interacts with the non-reporting funds regulations is complicated and may inadvertently provide for a measure of relief).

It is not clear at present whether there will be rebasing for partnership assets.

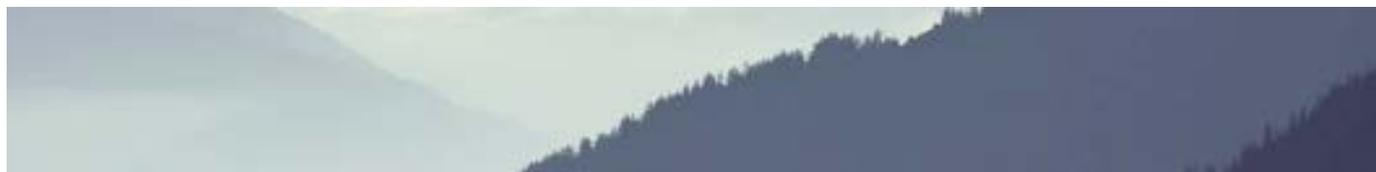
Where all the conditions are met, and the asset is disposed of at a gain on or after 6 April 2017, the base cost will be taken to be the market value of the asset as at 5 April 2017.

This means that where an asset eligible for relief has appreciated in value in the period up to 5 April 2017, the gain up to that date will fall away, **never to be subject to UK tax**, and the individual will only pay CGT on the increase in value since 6 April 2017.

Where the asset was originally bought using clean capital, the entire proceeds of sale could therefore be remitted to the UK with no further tax liability since:

- by virtue of the rebasing there is no tax on the pre 6 April 2017 gain; and
- the post 5 April 2017 gain will have suffered tax on the Arising Basis and no further tax is crystallised by a remittance of the proceeds.

Where the asset was acquired using unremitted Remittance Basis income or gains, the mixed fund rules will operate as normal when there is a remittance of proceeds and, depending on the amount and tax characteristics of what is remitted, there could be a further tax liability. It is thought that the amount of gain that is not subject to tax as a result of rebasing will be seen, for the purposes of the mixed fund rules, as a capital receipt in the tax year of disposal which could therefore be remitted to the



UK in priority to foreign income or gains of an earlier year which might have been used to acquire the asset. Proceeds realised during the two years to 5 April 2019 may be segregated after receipt under the cleansing rules described below.

An individual can elect for rebasing not to apply. The election is on an asset-by-asset basis, with the usual deadline of four years from the end of the relevant tax year (that is the year the disposal took place). Once made, an election is irrevocable.

### Cleansing mixed funds

This transitional rule offers an opportunity to de-segregate certain mixed funds. It is available to any foreign domiciled person (**whether UK resident or not as at April 2017**) other than a FDR. In the case of a non-UK resident, it will only be of relevance if he has previously been UK resident, used the Remittance Basis, has at least one mixed fund (explained briefly below) and intends to return to the UK.

A mixed fund can be a bank account (or similar cash account) or an asset (such as shares or a chattel). It is a fund which contains more than one category of income, capital gain or capital. There are a host of reasons why mixed funds arise, some of which are unavoidable. Where a remittance is made from a mixed fund, complex rules are engaged which determine what precisely is deemed to have been remitted and the order of matching is not generally favourable to the taxpayer.

Current tax law does not provide a mechanism to segregate the components of a mixed fund abroad. The transitional provisions allow for segregation of a mixed fund provided the re-arrangement occurs:

- during the transitional window (**6 April 2017 to 5 April 2019**); and
- at a time when the mixed fund consists of cash within bank or similar accounts.

Although the provisions only apply to bank or cash based accounts, an individual can sell a mixed fund asset either before or during the two year transitional window and segregate the resultant cash proceeds. If income and gains are realised as a result of a disposal in 2017/18, tax may be payable on the Arising Basis depending on the tax profile of the individual, but otherwise it should be possible to segregate component elements abroad without charge.

The August 2016 Consultation Document was clear that the transitional rule will not extend to those who are unable to identify the elements within the mixed fund(s). However, it was understood that the provisions were meant to be flexible such that it would not be necessary to establish ALL the relevant income and capital components within the mixed fund account in order to take advantage of the relief (doing so would often be impossible). For example, if it was possible to get to a position where it could be demonstrated that an account contained at least £X of capital, it was understood that this could be

segregated without determining the remaining elements.

The draft legislation on cleansing is highly problematic and does not make the position at all clear. It is understood that guidance will be issued and, whilst it is highly unsatisfactory, we will need to wait for this guidance before we have a proper understanding of how HMRC see this legislation working. It is hoped that there will be no change to the flexible position outlined above.

What we do know for certain is that:

- each cleansing exercise must be to a different account (that is there can only be one transfer from a mixed fund account (account A) to a transferee account (account B));
- there is no limit to the number of mixed fund accounts that can be cleansed.

In practical terms, those who can meet the conditions and wish to take advantage of the relief will need to establish new accounts for the different categories of income, gains and capital and move the different types of fund across to each account prior to 6 April 2019. The individual can then bring funds into the UK from the various accounts in the order most favourable to him, probably choosing first to exhaust the clean capital account, then capital gains with a foreign tax credit etc. There is no deadline set for bringing the funds into the UK and remittances can take place in later tax years after the transitional period has ended.

In some cases, regular mixed fund analysis of bank accounts will already have been undertaken (possibly at the same time as preparation of UK tax returns) and the information required to effect the re-arrangement will be readily available. In other instances this will not be the case and urgent consideration will be required as it may be necessary to contact banks, brokers and fund managers for the documentation (in some cases vital documents may be in danger of being destroyed due to their age). The mixed fund analysis may take many weeks and where the sums at stake justify the professional fees, it is sensible to agree the scope of any such analysis with specialist advisers sooner rather than later.

### Sundry transitional rules

A number of additional transitional provisions are being enacted:

1. One to avoid retrospectively prejudicing someone who returns to the UK within five years, and so triggers a charge to CGT on disposals of assets during the period of temporary non-residence, where at present the Remittance Basis could be claimed. Relief will apply where:
  - An individual ceased to be UK resident and had sold a foreign asset (realising a capital gain) before the date of the Summer Budget 2015 (8 July 2015);



- The individual returns to the UK after 5 April 2017, less than five years after departure, so that the temporary non-residence rules apply to tax the gain in the year of return;
  - The individual had expected to be able to claim the Remittance Basis on return and shelter the foreign gain, but is caught by the deemed domicile rule and, without transitional relief, would have been taxable on the foreign gain.
2. The Government has also confirmed that the Remittance Basis will apply where a deemed domiciled individual receives employment income relating to duties performed in a period before he became deemed domiciled.
  3. A gift of foreign property made by an individual when he was foreign domiciled and not deemed domiciled will remain outside the charge to IHT, even if the individual dies within 7 years, and at a time when he has become deemed domiciled.

The Government has rejected calls to introduce a transitional provision to prevent the new legislation from applying to individuals who left the UK and returned prior to Summer Budget 2015, having spent a period abroad of just sufficient length (4 years) to avoid being deemed domiciled for IHT under the existing rules and to re-set that clock. The new provisions will catch such individuals from 6 April 2017 and their deemed domicile status will be determined solely by applying the 15 out of 20 year rule.

## IHT

There are no transitional rules for directly held property.

The favoured IHT treatment for trusts settled by foreign domiciliaries who were not deemed UK domiciled at the time of settlement (excluded property trusts) will be preserved (except for FDRs), so trust property will be excluded from IHT:

- To the extent that it does not comprise UK assets, and;
- Provided that it is not property added after the individual became deemed UK domiciled.

## 9. Re-setting the clock

Individuals who have become deemed domiciled under the long-term resident rules will (provided that they are not FDRs) be able to shake off that status but, as far as CGT and Income Tax are concerned, not until they have been non-resident for 6 entire tax years. After such a period of absence (and assuming of course that upon re-establishing UK residence they do not acquire a UK domicile under general law) they would be able to return to the UK with the following tax profile:

- the anti-avoidance provisions for temporary non-UK residents will not apply;

- they will no longer be deemed domiciled and will be able to access the Remittance Basis for a further 15 years (provided they retain their foreign domicile under general law), with no Remittance Basis Charge being due for the first 7 years; and
- they will be able to claim overseas workday relief for the first 3 years, if they have an employment with overseas duties and remuneration is paid into an offshore account (specialist advice should be taken to maximise this potentially valuable relief).

For IHT purposes, the Government has decided for practical reasons (the difficulty of enforcement where the individual is non-resident) that where someone remains non-UK resident, the “domicile tail” should be shorter. Deemed domicile will be lost for IHT purposes if the individual is not UK resident in the relevant tax year and has not been UK resident in any of the preceding 3 tax years.

No changes are proposed for someone who has made the spousal deemed domicile election (in order to avoid IHT on the death of a UK domiciled spouse). As is the case now, 4 years of non-UK residence will be required to lose elected spousal deemed domicile status.

## 10. Protection of non-UK resident trusts

The current proposals need to be read in conjunction with the general changes (see section C) to the operation of the Income Tax and CGT anti-avoidance provisions for non-UK resident trusts.

Without special provisions, settlors who have become deemed domiciled by virtue of being long-term residents would be subject to tax in the same way as UK domiciliaries. Provided the protection is not forfeited, these provisions provide for a half-way house. Those affected are not taxed as favourably as they were before they became deemed domiciled but their position is significantly better than that of UK domiciliaries.

Draft legislation for Income Tax has still not been published but we understand that for Income Tax and CGT protection will only be available where:

1. The settlor retains his foreign domicile under general law.
2. The settlor is not an FDR.
3. The trust was established before the settlor became deemed UK domiciled.
4. The trustees are non-UK resident in the tax year.
5. Property is not provided (directly or indirectly) for the purposes of the trust, at a time when the settlor is deemed UK domiciled, by (i) the settlor; or (ii) the trustees or any other trust of which the settlor is a beneficiary or settlor.

It would appear that the provision of property to a company held by a trust will be seen as indirect provision of property.



Breaching condition 5 would result in the protections being forfeited and the individual being taxed for Income Tax and CGT purposes in the same way as a UK domiciliary.

Property will not be treated as having been added to the trust where:

- it was provided under a transaction entered into at arm's length. This is the wording adopted in the draft legislation and assuming that it was intentional, it would suggest that no transactions between connected persons can come within this category;
- it was provided by any person in pursuance of a liability incurred by any person before 6 April 2017; and
- the trust's expenses relating to taxation and administration exceed its income for that year and the addition of property is provided purely to meet this deficiency in whole or in part.

The above is problematic for a number of reasons. In particular no provision is made to add funds to meet capital expenses or expenses of any underlying company that might exist.

The position with respect to interest free loans is also unclear. If such loans are provided between connected persons, as will generally be the case, they may never be seen as at arms length. Where such loans are already in place, failure to demand repayment may be seen as the provision of funds.

When changes to the tax treatment of non-resident trusts were made during the early 1990s, HMRC issued a Statement of Practice that, amongst other things, confirmed that it viewed the making of such loans as a provision of funds, and we have no reason to think HMRC will have changed its views in the meantime. It therefore seems likely that interest free loans made after the settlor becomes deemed domiciled will be seen as a provision of property. Whether existing loans will be so regarded is a different issue. Again looking to what happened in the early 1990s it appears that a fixed term interest free loan may not be caught (though there will be an issue should it not be repaid on or before the fixed term expires) but there will be an issue with a repayable upon demand interest free loan.

For settlors who have made interest free loans to offshore trusts and who will be deemed domiciled as at 6 April 2017 the situation needs to be considered urgently. It may be possible to change the terms now; repayment of the loan could be considered or charging interest.

A similar concern arises in relation to revocable trusts (which may be commonly found in connection with US planning). Could the failure to revoke at any time be seen as the provision of property?

## Income Tax

There are two Income Tax anti-avoidance codes

which can apply to the income of non-resident trusts (and foreign companies owned by such trusts) so as to deem the income as that of a settlor:

- the settlements regime;
- the transfer of assets abroad provisions (TOAA).

These two codes can operate in parallel, though where it applies the settlements regime takes precedence.

We do not have draft legislation for the Income Tax provisions, so this section is based solely on the Response document.

UK income of a trust will continue to be subject to UK tax on the Arising Basis in the hands of the settlor (where the settlor or his spouse can benefit under the trust) under the settlements regime (in the case of income arising to the trust) or under the TOAA transferor charge (in the case of income arising to a company or other entity or person). The TOAA charge would apply, therefore, to income arising to a foreign company held by a trust. However, in certain cases the TOAA may be excluded through a motive defence or EU law.

Provided the trust does not forfeit protection the deemed domiciled settlor will be taxed on foreign income by reference to the benefits:

- he receives; or
- close family members receive (unless the benefits are subject to tax on the family members).

As a deemed domiciliary the settlor will be subject to tax on worldwide benefits, not just on those received or enjoyed in the UK.

In a welcome move, the suggestion in the August Consultation Document that the income arising to an underlying company owned by the trust would only be protected where it was actually distributed to the trust in the tax year (so as to become income of the trust) has been dropped.

The definition of "close family members" is the same as in the CGT legislation and is:

- the settlor's spouse, civil partner or cohabitee; or
- a minor child of the settlor or his spouse/civil partner/cohabitee.

## CGT

A UK resident and domiciled settlor is taxable on the gains of a non-resident trust if he or his immediate family can benefit (this is referred to as the "settlor charge"). He may also be taxable on gains of non-resident companies owned by the trust. The definition of "immediate family" includes not only the settlor's spouse and minor children and grandchildren, but also children and grandchildren of any age and their spouses.

At present, a foreign domiciled settlor is exempt from these attribution provisions, regardless of whether the



Remittance Basis is claimed. Foreign domiciled settlors are only subject to tax on the more favourable “attribution charge”. In line with beneficiaries who are not settlors, a foreign domiciled UK resident settlor can only be taxed on trust gains where they are matched to payments made or benefits received from the trust (and in such cases the Remittance Basis, if it is claimed, will shelter unremitted foreign payments and benefits). Furthermore, Finance Act 2008 enacted transitional provisions (for all foreign domiciliaries who receive benefits from non-UK resident trusts) that can restrict liability to gains accruing after April 2008, since the CGT attribution provisions did not apply at all to foreign domiciliaries before then. These provisions remain in force for long-term residents (the legislation revokes them for FDRs).

Capital gains of new trusts set up on or after 6 April 2017 by an individual after he has become deemed domiciled will be subject to the settlor charge in exactly the same way as described above for a UK domiciliary.

A settlor who funded the trust (whether before or after 5 April 2017) before becoming deemed domiciled will, as long as the trust retains protected status, only be taxed on trust gains by reference to capital payments or benefits:

- he receives; or
- potentially those close family members receive (see section C).

As a deemed domiciliary the settlor will be subject to tax on payments or benefits wherever received.

The close family member definition is aligned with that for income tax and is provided in the sub-section above.

## 11. Non-resident companies

There are no protective measures for individuals subject to the TOAA or the CGT anti-avoidance provisions relating to non-resident companies in which they are shareholders. Such individuals may be subject to tax on corporate income and gains on a worldwide basis (subject to specific exemptions from these provisions and the availability of relief under Double Taxation Agreements).

## C. Non-UK Resident Trusts

In an extension to the Summer Budget 2015 announcements, the Government set down in the December 2016 Response Document plans to:

- Change the valuation principles for beneficiaries receiving a non-monetary benefit or capital payment from a non-UK resident trust.
- Change the way the Income Tax anti-avoidance rules for non-UK resident trusts work for all settlors

who are foreign domiciled under general principles.

- Make changes to the CGT anti-avoidance provisions for non-UK resident trusts that will potentially impact on all non-resident trusts and their beneficiaries.

The changes will be effective from 6 April 2017.

## 12. Valuations

The December 2016 Response Document includes a specific section on valuation of non-monetary benefits and capital payments. Legislation is to be introduced for the main classes of asset with the following being proposed in the Response Document:

- The benefit of the use by a beneficiary of art owned by the trust will be quantified by:
  - multiplying the acquisition price by the official rate of interest for the tax year; and
  - subtracting payments made by the beneficiary for use of the art (including insurance and storage costs).
- A fixed value for the taxable benefit of chattels is proposed which could be eliminated by payment of consideration equal to that amount and reduced by a lesser amount of consideration being paid.
- For loans there will only be no benefit where the interest is actually paid. Where interest is rolled up there will be a deemed tax charge calculated on current principles for interest free loans (so the benefit is determined by reference to the official rate of interest). If interest is paid but is less than the amount due under the official loan rate calculation, the benefit will be the difference between the two. We do not have the draft legislation but it seems likely that this change in the legislation will be drafted to catch deep discounted securities also.

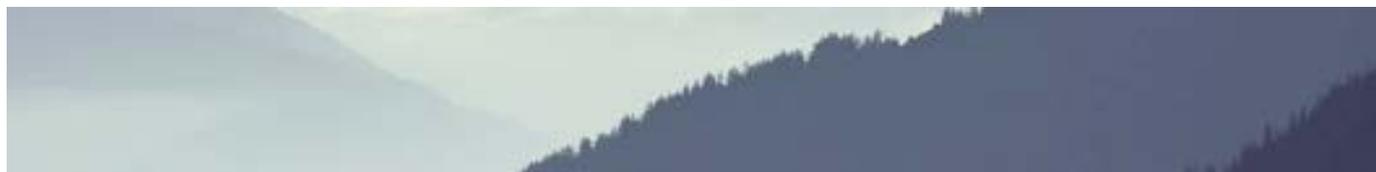
## 13. The Income Tax provisions

We do not have the draft legislation so the explanation here is taken from our understanding of the proposals as set down in the December 2016 Response Document.

It appears that there will be no change to:

- the way in which UK domiciliaries are taxed; or
- how foreign domiciliaries are taxed on UK source income.

The changes are with respect to the taxation of foreign income arising to trusts with a foreign domiciled settlor. The proposal is for a new charge to be introduced. The foreign income will be pooled and matched to benefits received by the settlor or, potentially, by close family members (it appears that



the income will not be aggregated and charged on the settlor if the close family member suffers tax on it). “Close family member” is defined as:

- the settlor’s spouse, civil partner or cohabitee; or
- a minor child of the settlor or his spouse/civil partner/cohabitee.

Where a family member is subject to tax it will either be on a straightforward income distribution or under the TOAA non-transferor charge legislation on a matching basis taking into account the benefit received and the relevant income in the trust that could be used to benefit them). The status of the beneficiary will determine whether the Remittance Basis can be claimed to defer or avoid UK tax on the distribution.

It is understood that undistributed income within the whole structure (so at both trust and underlying company level, if applicable), will be swept into the pool as at the start date of 6 April 2017 and will be available for matching to any benefits received after 5 April 2017 by the settlor. The exception to this will be income that has already been taxed on the settlor. Such income will not form part of the income within the pool.

It is not clear how the new pool for settlors and the relevant income pool in relation to trust beneficiaries will interact. To avoid double taxation there should be provisions so that income taxed under one pool is removed from the other. Hopefully the draft legislation will cover this area.

A foreign domiciliary under general law who does not meet the 15 out of 20 test can shelter foreign benefits from UK tax by claiming the Remittance Basis (depending on the period of UK residence this might come at the cost of paying the £30,000 or the £60,000 Remittance Basis Charge). Provided trust protection is not lost, a deemed domiciled long term resident will be subject to tax on worldwide benefits matched to income. If there is insufficient income it is assumed that the benefits will be carried forward to future years to be matched.

The change means that the foreign income arising within the trust will not be seen as being the income of the non-domiciled settlor (as it is at present for a settlor interested trust), so there will no longer be the danger that the trustee (as a relevant person in connection with the settlor) might inadvertently remit it to the UK, resulting in a possibly significant Income Tax charge on the settlor.

The current law will continue to apply post 5 April 2017 for unmatched pre 6 April 2017 benefits.

## 14. Capital Gains Tax

A basic overview of the current anti-avoidance provisions for non-UK resident trusts was provided in section 6 (in the CGT sub-section). No changes are proposed to the provisions as they apply to UK

domiciled settlors. The changes are all to the attribution charge legislation and apply to everyone (regardless of domicile status) who receives benefits while UK resident (or only temporarily non resident).

It is understood that there will be transitional provisions, such that for the purposes of taxing the settlor, the current rules apply when considering any capital payments or benefits received before 6 April 2018, that is:

- the close family aggregation rule (see below) will not apply so capital payments and benefits to other family members will not be attributed to the settlor provided they were made before 6 April 2017; and
- there will be no tax for a Remittance Basis user, unless the settlor or any other relevant person remits the capital payment or benefit and it can be traced to income or has been matched to trust gains.

### **Cases where the settlor will be subject to tax on capital payments made to close family.**

There are certain circumstances where, in addition to any gains attributed to capital payments made to him, the settlor will be subject to tax on gains attributed to capital payments made to close family members (defined as for the Income Tax provisions described in section C2 above).

These aggregation provisions only apply where the close family member is not subject to tax on the capital payment. That may be the case where the close family member is:

- not UK resident in the year; or
- claiming the Remittance Basis and no remittance of the capital payment received has been made in the year (a partial remittance of a token amount appears, based on the draft legislation, to be sufficient to secure that these provisions do not apply).

Where the provision does apply, the settlor will be subject to CGT on the gains attributed as if they were his own. The settlor has a right to recover from the trustees (or the beneficiary, though this seems less likely to happen) any UK tax he pays on the gains attributed to him as a result of a benefit conferred on close family members. There is no allowance for foreign tax suffered by the beneficiary.

### **Disregard of capital payments to non-residents**

The attribution CGT anti-avoidance charge works by matching trust gains to capital payments (including benefits). This matching has always applied to all capital payments made, regardless of the residence or domicile status of the individuals receiving them. Accordingly, gains could be “washed out” of non-UK resident trusts by capital payments being made to non-residents (such payments not being within the scope of UK CGT though or course they may be subject to tax in the jurisdiction where the non-



resident beneficiary lives).

From 6 April 2017 the legislation is being changed so that capital payments to non-UK residents will be disregarded (unless the settlor is UK resident and subject to UK tax on the payment as a result of the close family members' aggregation rule). The change applies both to capital payments made in 2017/18 and subsequent years and to unmatched capital payments to non-resident beneficiaries made prior to 2017/18. It may therefore be important to realise sufficient capital gains by 5 April 2017 to frank otherwise unmatched capital payments made to non-residents in 2016/17 or earlier tax years.

There is a special provision that applies in the tax year that a trust ceases to exist. In that tax year only, capital payments to non-resident beneficiaries are matched to the trust gains pool.

*For example:*

- where the trust property is £18 million in cash;
- gains are £6 million;
- there are three beneficiaries, one of whom is UK resident and two of whom are non-UK resident in the tax year that the trust ceases; and
- the trust property is divided equally amongst the beneficiaries so that they each receive £6 million.

*The gains will be treated as been attributed to each beneficiary such that the UK resident is only taxable on £2 million.*

### **Disregard of payments to temporary non-residents**

Temporary non-UK residents (individuals who return to the UK before five years of non residence have elapsed) are potentially subject to UK tax in the tax year (or part of the tax year, where split year applies) of return to the UK on all capital payments made in the non-resident period (foreign domiciliaries who are not deemed domiciled can claim the Remittance Basis to shelter the gains where there have not been remittances). For the purposes of this legislation, the capital payments made to them while non-resident will be taken into account in the tax year of return to the UK.

### **Disregard of payments to migrating beneficiaries**

In addition to disregarding capital payments made to non-residents, a further provision causes capital payments to be disregarded where they are made in anticipation of the beneficiary leaving the UK. The legislation applies where:

- the capital payment is received by a beneficiary of the trust in a tax year before one in which there are sufficient trust gains to be matched to it;
- the beneficiary is UK resident in the tax year that the capital payment is received; and
- the beneficiary is not UK resident in the tax year that gains arise and would otherwise be matched to the earlier capital payment.

This legislation will catch unmatched capital payments made prior to 6 April 2017 in addition to those made after 5 April 2017.

### **Anti conduit rule**

There is a convoluted provision in the draft legislation that is aimed at preventing tax being avoided by:

- distributions being made to an individual (the trust beneficiary) who can shelter them from UK tax (either as a result of being non-UK resident or through being a Remittance Basis user); and
- the individual making a gift on to someone who would have been subject to tax if he had received the payment from the trust directly. "Gift" is not defined but is intended to include a loan, though presumably not one made on arm's length terms where interest is actually paid.

The legislation applies to all onward gifts after 5 April 2017 (so the date the capital payment is received by the trust beneficiary is not relevant).

The legislation is not in point where the original beneficiary is a close family member of the settlor and the settlor is subject to tax on the capital payment.

There are two rules, one in relation to time and one with respect to intention.

Broadly, the provisions for the rule in relation to time will be triggered where the beneficiary makes (directly or indirectly) a gift to any individual (whether a beneficiary of the trust or not):

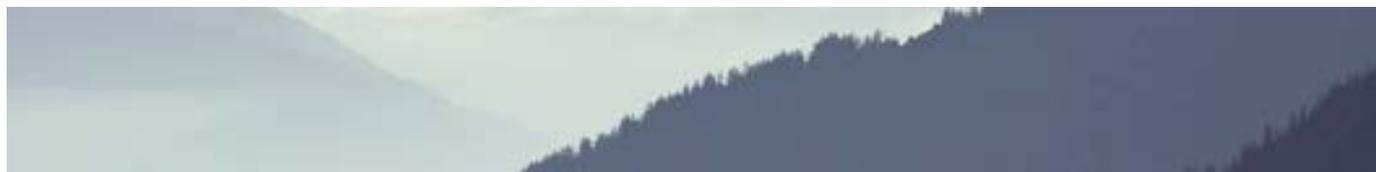
- within three years of receiving the capital payment from the trust; or
- before receipt of the capital payment from the trust but at a time when it was reasonable to assume that the gift made was in anticipation of the capital payment.

The provisions for the rule with respect to intention will be triggered only where the gift is made as part of any arrangements designed to result in the whole or part of the capital payment being received by another trust beneficiary. In that situation, the three-year time limitation is removed and an onward gift even after three years would be caught.

Two other conditions need to be met:

- in the tax year in which the gift is made the recipient is UK resident; and
- the donor is either not UK resident or a Remittance Basis user in that tax year.

There are serious potential problems with the scope of this legislation, not least because the "three year rule" contains no requirement for a link between the capital payment to the beneficiary and the onward gift. As such, "innocent transactions" such as using some of the funds to pay for items like Christmas and birthday presents could result in a tax charge (the gift recipient being treated as receiving the capital



payment either in the tax year the gift was received or, if earlier, the tax year the trust ceased to exist). There are also concerns about the interaction between this legislation and the legislation for temporary non-residents if the trust beneficiary falls into that category and returns in a tax year after the gift has been made.

Where the provision is triggered, the amount that can be matched is limited to the lower of the onward gift and the original capital payment, less any amount already subject to tax as a result of previous gifts.

### Foreign domiciliaries

Foreign domiciliaries who do not meet the 15 out of 20 test can shelter foreign benefits from UK tax by claiming the Remittance Basis (depending on the period of UK residence, this might come at the cost of paying the £30,000 or the £60,000 Remittance Basis Charge). Provided protection is not lost, (in which case the settlor charge will apply on all the trust gains arising on a worldwide basis in that year and subsequently) a deemed domiciled long term resident will be subject to tax on worldwide capital payments matched to trust gains. If there are insufficient trust gains the benefits will be carried forward to future years to be matched.

## D. Extending IHT to Enveloped UK Residential Property

### 15. The basic provisions

Domicile rather than residence is the crucial concept when considering an individual's exposure to IHT.

Foreign assets (referred to as "excluded property") are outside the scope of IHT when owned by individuals who are neither UK domiciled nor deemed domiciled, or by trusts settled by individuals who met those criteria at the time the settlement was made. Up to now, there have been no "look through" provisions for IHT, so that UK assets can be held within a foreign company, or similar opaque foreign entity, and be effectively excluded by such means. This technique ('enveloping') is frequently used to shelter UK residential property from IHT. It has continued to be effective for IHT, albeit at the potential cost of exposure to the Annual Tax on Enveloped Dwellings ("ATED") charge since 2013. Indeed, the IHT benefit was a significant factor in discouraging de-enveloping when ATED was introduced in 2013 (along with the lack of any SDLT relief or CGT roll-over).

With effect from 6 April 2017, the rules will be changed so that shares in offshore companies which would be close companies if UK resident ('foreign close companies'), and shares or capital in similar entities, will no longer be excluded property if and to the extent that the value of the shares or capital is attributable to UK residential property. The definition of "property" for these purposes is discussed below.

These changes will extend to overseas partnerships owning UK residential property.

It had been hoped that the legislation would be drafted so that it would not apply merely because there is a group and a foreign close company within that group structure. However, this is not the case in the legislation as currently drafted and clarification is being sought as to what the intention is.

The 5 December 2016 draft legislation provides only a very limited de minimis exemption. Qualifying interests will be disregarded where the foreign domiciliary or trust has less than 1% of the value of all the rights or interests in the foreign close company or the interests in the offshore partnership.

Where the foreign entity is within the scope of the legislation and there is an interest in UK residential property, the change takes this category of asset outside of the excluded property definition completely for individuals and trusts. This means that all of the normal IHT chargeable event rules will apply.

A number of additional IHT charging measures were announced on 5 December 2016 which significantly extend the scope of the changes. These are in respect of:

- "relevant loans";
- money or money's-worth held or otherwise made available as security, collateral or a guarantee for a relevant loan; and
- disposal proceeds from the sale of a qualifying property interest and the funds on the repayment of a relevant loan. These rules only apply to sales and loan repayments after 5 April 2017.

These new provisions (including the "relevant loan" definition) are discussed in later sections.

The draft legislation also contains a paragraph dealing with double taxation arrangements under international tax treaties. This specifies that the new IHT taxing provisions will override the provisions in any double tax treaty if:

- no tax of a character similar to IHT is charged on the chargeable IHT event; or
- a tax of a character similar to IHT is charged but at a rate of 0%.

### 16. UK residential property interest

The Government made it clear from the start that the extension of IHT to UK residential property was to be wide, applying without a threshold or reliefs (eg, for property let out commercially). Since it was generally felt desirable not to have new definitions, the definition of 'interest in UK land', 'dwelling' and 'contract for an off plan purchase' are linked to the legislation governing the charge to CGT on non-UK residents.

The CGT definition covers a property:

- suitable for use as a dwelling; or



- in the process of being constructed or adapted for such use.

Land which at any time is, or is intended to be, occupied or enjoyed with a dwelling as a garden or grounds (including any building or structure on such land) is taken to be part of that dwelling at that time.

A building is not a dwelling if it is used as:

- residential accommodation for school pupils;
- residential accommodation for members of the armed forces;
- a home or other institution providing residential accommodation for children;
- a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disability, past or present dependence on alcohol or drugs or past or present mental disorder;
- a hospital or hospice;
- a prison or similar establishment;
- a hotel or inn or similar establishment;
- an institution (not falling within any of paragraphs above) that is the sole or main residence of its residents; or
- student halls of residence or purpose-built student accommodation (specific criteria must be met one of which is a requirement for 15 bedrooms or more).

A building which becomes temporarily unsuitable for use as a dwelling is treated as continuing to be suitable for such use but there are specific rules which apply where there is damage to the dwelling or works are being undertaken.

## 17. Changes of use

Property can change its use from residential to commercial or vice versa. In the August 2016 Consultation Document, the Government suggested having a two-year look back period, so that if the UK property had been residential in any part of this period it would be caught. Various representations pointed out that this went against the fundamental 'snapshot' principle behind IHT and this provision has been dropped. Now it is just the position at the time of the chargeable transfer that is relevant.

## 18. Duality of use

A property might be used for both residential and commercial purposes (the example given in the August 2016 Consultation Document being a flat above commercial premises). The current draft legislation does not contain provisions to deal with this situation but the 5 December 2016 Response Document states that there will be a rule in the Finance Bill 2017 legislation to deal with this situation.

## 19. Valuation

The IHT change is given effect by modifying the meaning of 'excluded property', so that it will no longer cover shares or capital in an offshore entity that holds a chargeable interest in or over UK residential property. The draft legislation contains no special valuation provisions. It therefore follows that when a chargeable event occurs, it is the value of the holding in the owning entity that is required, not the value of the property itself. It also follows that where there is a minority holding in the owning entity, the discount to apply to reflect the value of the minority interest will result in a lower value than if one simply took a pro rata percentage of the value of the entire underlying property).

Having said this, the December 2016 Response Document refers to the valuation being based on the open market value of any UK residential property within an estate and talks of more detailed rules being included in the draft legislation to deal with situations in which a residential property is held in more complex structures. It is therefore possible that there will be draft legislation published on this in due course.

Where the owning entity has assets other than UK residential property, it will be necessary to assess only the value attributable to the UK residential property in establishing the participation in the owning entity that does not qualify as exempt excluded property.

## 20. Deduction of debts

Where there is just UK residential property within the owning entity, debts can be offset for IHT purposes in determining the value of participations deriving from UK residential property. There is, however, a special rule for the attribution of its liabilities where the owning entity has other assets. In such a case it appears that, even if the debt is secured against the UK residential property, for the purposes of this IHT charge the debt is allocated across all the assets in proportion to their market value at the time of the chargeable event. This is best explained by way of an example.

*Miss Honeypot is a UK resident foreign domiciliary (who is not deemed UK domiciled). She owns all of Honeypot Overseas Ltd. In turn the company owns all of Honey Mews a UK residential property worth £10 million and an offshore share portfolio worth £90 million. A mortgage of £5 million was taken out by the company to acquire Honey Mews and is secured on the property.*

*The provisions mean that only one tenth of the £5 million mortgage can be deducted in calculating the value attributable to UK residential property.*

The position with respect to any debts the foreign domiciliary or non-UK resident trust may have taken out to acquire the holding in the owning entity is not discussed. As such, it seems that the normal rules with respect to deductibility of debts will apply.



## 21. Relevant loans and collateral

In addition to the original proposals to extend the scope of IHT to UK residential property held within foreign close companies and within offshore partnerships, there will be IHT exposure where:

- there is a “relevant loan” (this provision applies to all loans not just those between connected parties); or
- money or money’s worth is used as security, collateral or a guarantee for a relevant loan; or
- the right or interest that a participator has in a foreign close company (or that a partner has in an offshore partnership) is directly or indirectly attributable to a “relevant loan” or to the collateral for a relevant loan.

A loan is a “relevant loan” where money or money’s worth is made available (directly or indirectly) and is used to finance:

- the acquisition of a UK residential property interest by an individual, a partnership or the trustees of a settlement;
- the maintenance or enhancement of the value of a UK residential property interest where the UK residential property interest is the property of an individual, a partnership or a settlement; or
- the acquisition by an individual or by the trustees of a settlement of:
  - a right or interest in an offshore company that would be close if UK resident; or
  - an interest in an offshore partnership,provided the acquisition funds are used for the acquisition, maintenance or enhancement of UK residential property.

It should be noted that it is what the borrower does with the funds that is relevant, not the intention of the lender when the loan was made. Where loans have been made it will, therefore, be necessary to make enquiries to see if these new provisions will apply.

These new charging provisions have the potential, effectively, to duplicate liabilities and the amount subject to IHT could significantly exceed the actual value of the UK residential property. The potential problems are best explained by way of an example.

*Miss Rabbit is a UK resident foreign domiciliary (who is not deemed UK domiciled). She owns all of Carrot Overseas Ltd. In turn the company owns all of Carrot & Lettuce Mews, a UK residential property worth £40 million and an offshore share portfolio worth £60 million. A loan of £20 million was obtained from a non-resident family discretionary trust to acquire Carrot & Lettuce Mews. The trust secured the loan on the share portfolio.*

*In this example we have:*

- 1) *A qualifying interest in UK residential property. The provisions mean that only four tenths of the*

*£20 million mortgage (£8 million) can be deducted from the value of the property in ascertaining the value of Carrot Overseas Ltd which derives from UK residential property, so Miss Rabbit has £32 million that will be subject to IHT should a chargeable event occur (such as her death).*

- 2) *There is a relevant loan of £20 million that will be relevant property within the family trust (so has to be taken into account for exit charges and decennial charges).*
- 3) *Whilst it is unclear there is concern that the entire £60 million of collateral provided for the loan is also caught by these provisions and, therefore, within the estate of Miss Rabbit.*

It is hoped that the legislation will be amended so that IHT cannot be charged on an amount in excess of the value of the UK residential property and to introduce ordering provisions (or just and reasonable provisions) where there are potential multiple charges.

There is no exemption in the current legislation for banks lending in the ordinary course of business. In most cases the bank is likely to be a non-close body corporate, so there would not be an issue as the bank will not make chargeable transfers of value or die. There could, however, be cases where the bank is close (such as where it is controlled by a partnership). In such cases there could be an issue.

It is unclear what the intention is where these new charges interact with Business Property Relief (BPR). There does not appear to be anything in the legislation published to date to suggest that BPR should not apply where the provisions are met. As such it is hoped that, in a situation where a bank which is close makes commercial loans to clients for the acquisition, maintenance or enhancement of UK residential property, BPR will apply to the value of the interest in the company that could be seen as attributable to relevant loans. This is another issue with respect to which clarification will be sought.

## 22. Disposals and repayments

There are also anti-avoidance provisions which apply where, after 5 April 2017, a UK residential property is sold or a relevant loan is repaid within two years of a subsequent chargeable event for IHT purposes. These provisions apply:

1. to property which constitutes consideration in money or money’s worth for the disposal of a foreign close company or offshore partnership through which there was an interest in a UK residential property or a relevant loan (though note the transitional provisions specify that this does not apply where the property was disposed of prior to 6 April 2017);
2. to repayment of relevant loans (though note the transitional provisions specify that this does not apply to any repayments made prior to 6 April 2017);



3. to any property directly or indirectly representing property within 1 and 2 above.

These provisions appear only to apply to sales of interests in the foreign company or partnership themselves and not to disposals by such enveloping entities – so that a company which sold its UK residential property and re-invested the proceeds in other sorts of asset would cease to be caught by these provisions. It is possible that, as the draft legislation refers to property which “directly or indirectly” represents such property, the undistributed proceeds of sale may be seen as indirectly represented by the shares etc, but this does not seem to be what the draft provides. However, further refinement of the draft legislation may be made to counter avoidance by sales of an entity’s underlying assets.

During the two-year period the property will continue to be subject to IHT. Where there is a disposal the two-year period runs from the disposal date. Where there is a loan repayment the two-year period runs from that date.

From the way in which the current draft legislation is worded, there appears to be an indefinite look back period (not merely two years, which applies to individuals and qualifying interest in possession trusts) where the trust is discretionary or where it is a non qualifying interest in possession trust. It is not clear if this was intentional (it would seem exceptionally harsh) and clarification will be sought.

## 23. Anti-avoidance

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The Government is keen that the extension of IHT to enveloped property is not circumvented. With this in mind, a specific targeted anti-avoidance rule (TAAR) will be introduced so that any “arrangements” will be disregarded where their purpose or one of their main purposes is to secure a “tax advantage” by virtue of not being caught by the new provisions.

“Arrangements” are defined as including any scheme, transaction or series of transactions, agreement or understanding (whether or not legally enforceable and whether or not entered into) and any associated operations.

“Tax advantage” is defined as:

- relief or increased relief from tax;
- repayment or increased repayment of tax;
- avoidance or reduction of a charge to tax or an assessment to tax;
- deferral of a payment of tax or advancement of a payment of tax; and
- avoidance of an obligation to deduct or account for tax.

The extension of IHT to enveloped property does not take effect until 6 April 2017. Whilst it is not entirely clear what the position will be, it could reasonably be thought that the TAAR should only apply to transactions entered into after 5 April 2017, which is understood to be the current HMRC view. Clearly any

transactions prior to Summer Budget 2015 (8 July 2015) should not be caught by the TAAR. Such transactions could not possibly have been carried out with a view to side-stepping these provisions, which were only announced by the Chancellor on 8 July 2015.

## 24. No transitional reliefs

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The Government has rejected calls for a de-enveloping relief to allow existing structures to be wound up without triggering unexpected/onerous tax liabilities. The August 2016 Consultation Document stated that the Government can see that there might be a case for encouraging de-enveloping but it “does not think it would be appropriate to provide any incentive to encourage individuals to exit from their structures at this time”.

Many individuals and trustees holding UK property within offshore companies were waiting to see whether there would be a de-enveloping relief before taking action. The August Consultation Document comment indicated that this was very unlikely, and the December 2016 response document is categorical in its rejection of any such relief.

Where this has not been done already, structures affected by these changes need to be evaluated (with the tax consequences of closing down the structure assessed against the tax costs of keeping it). Where a decision is taken to close down the structure, it may well be necessary to aim to do so by 5 April 2017. The practicalities (eg, ensuring that the professionals needed in the offshore jurisdictions are available) to get the work completed in the time available need to be attended to as quickly as possible. Accordingly, those affected need to seek specialist UK tax advice urgently.

## 25. Collection of tax

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The Government recognises that HMRC could have some difficulty in identifying when a chargeable event has taken place and a liability to tax has arisen.

To assist in collection, HMRC is to have an extended power to impose a legal charge on UK residential properties. In the August 2016 Consultation Document it was suggested that legal owners of the company be made liable for the IHT, and that this would include directors of the company that holds the property. The Government has listened to representations that placing a charge on directors might not be fair (as they might not know that a chargeable event has been triggered) and is considering alternative approaches.

It will be even more difficult for HMRC to police the new charges on relevant loans and collateral.

## 26. Going forward

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Whilst it is still possible that owning commercially let properties through a corporate structure may in certain circumstances recommend itself, there is no longer a

UK tax advantage in owning a UK residential property for private use through a corporate vehicle. Indeed, with the move to beneficial ownership registers, even the privacy benefits of using such companies will gradually be eroded.

## E. Business Investment Relief

Business Investment Relief (BIR) was introduced in 2012/13 to enable UK resident foreign domiciliaries to bring Remittance Basis foreign income and gains into the UK to invest in qualifying UK companies. Provided the conditions are met, bringing the funds to the UK to make the investment will not give rise to a taxable remittance. In various respects the conditions are narrowly drawn, which is probably why the uptake has been lower than the Government had hoped for.

Following up on an earlier commitment, the August 2016 Consultation Document contained a chapter asking for suggestions on how BIR could be changed to encourage greater investment into UK businesses.

A limited number of changes will be made in the Finance Bill 2017, to have effect from 6 April 2017:

- The “extraction of value” rule is to be modified. Because of the “involved company” definition, this was so wide that it could catch any benefit received from any connected company, even where there was no trading connection at all between the connected company and the BIR investment. The scope of the “extraction of value” rule is to be narrowed by the removal of the reference to “involved company”.
- A new hybrid company category will be added to the list of qualifying investments for BIR purposes. This will mean that a company that both trades and is a stakeholder company will be able to qualify. Currently a company can only qualify if it is one or the other, it cannot be a mixture of both.
- The time limit for investing in a company before it starts to trade will be increased from two to five years.
- The relief will be extended so it applies to acquisitions of existing shares as well as new subscriptions.
- The grace period (the period within which the individual has to remove their funds to avoid being taxed on the remittance) will be increased to enable any income or gains to remain in a non-operational company for up to two years from the time the individual realises it has become non-operational. This has been introduced to allow sufficient time for the consideration of alternative trading activities.

There is a commitment to give further thought to some of the representations made in response to the August 2016 Consultation Document with a view to possibly putting changes through in a later Finance Bill. The dislike of partnerships still seems to be there and it seems unlikely that there will be a general extension to allow investment in partnerships. Indeed, legislation has been put through Finance Bill 2017 to make it clear that for BIR purposes corporate partners are not treated as carrying on a trade by virtue of the partnership carrying on a trade (this has always been the view of HMRC but it was not shared by all respondents to the consultation document).

## F. And Finally

This briefing sets out the latest position with respect to the changes to the taxation of foreign domiciliaries and non-UK resident trusts and is based on the information released on and before 5 December 2016. Unfortunately, there are a number of key areas where the final position is not clear. In some cases we expect further legislation. In others, clarification is being sought from HMRC. Consultation on the draft legislation continues until 31 January 2017 and it is hoped that changes will result from this. We will provide updates as and when new information is available.

One thing that is clear is the magnitude of these changes. Those who will become deemed domiciled, trustees of non-UK resident trusts and anyone owning a non-UK resident corporate entity that in turn owns UK property should urgently review their position with specialist UK tax advisers. There are pitfalls and (depending on circumstances) opportunities and the right advice is essential in determining what action should be taken.

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