An unwelcome bolt from the blue!

BRIEFING

May 2017

Introduction

Whatever their domicile status, taxpayers like certainty. They do not like to feel as if the rug has been pulled from beneath their feet and that they have been placed in a state of limbo. Unfortunately the Snap General Election, and the related decision announced on 25 April 2017 to drop every single provision relating to foreign domiciliaries from the initial Finance Act 2017, has caused precisely that.

As far as we know, this does not signal an intentional policy change. The Snap General Election was called for entirely different reasons. The provisions were dropped at the request of the Opposition, but there have been no indications that this should be taken to mean anything more than that there was a desire for such complicated legislation to be scrutinised properly in Parliament rather than rushed through a truncated Finance Bill. Indeed, the Financial Secretary to the Treasury, in a statement in the House at the Committee stage of review, confirmed that the dropped provisions remained Government policy and would be enacted at the earliest opportunity at the start of the next Parliament.

At this stage, whilst nothing is certain, we believe that the most likely outcome is that in the Autumn/Winter there will be a Finance Act (No 2) 2017 that (perhaps with a few technical amendments which will hopefully improve the legislation) reinstates all the provisions relating to foreign domiciliaries with effect from 6 April 2017.

Less likely possibilities are:

- Deferring the provisions until Finance Act 2018, with them being effective from 6 April 2018.
- Dropping the provisions entirely (though, given the Financial Secretary to the Treasury's statement (discussed above), this is only likely if a different Government comes in after the General Election, in which eventuality the position would be altogether more unpredictable).

In this update we will start with an overview of the provisions that have been dropped and then move on to the issues for individuals and trustees affected by this state of limbo.

Overview of what has been dropped

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 the most significant package of changes for foreign domiciliaries since 2008, particularly as they covered the Remittance Basis and Inheritance Tax (IHT).

The main changes can be summarised as follows:

1. 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 IHT if the individual was not UK resident in either of the preceding two tax years);
2. 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;
3. 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.

Despite calls for de-enveloping relief (to mitigate or defer taxes in unwinding structures rendered ineffective) in the wake of the extension of the IHT announcement, the Government declined to introduce any such legislation.

RAWLINSON & HUNTER

The Government did, however, undertake to introduce the following reliefs/protections:

- Capital Gains Tax (CGT) rebasing relief on assets held directly by individuals (it is understood that this also includes partnership assets), to apply to income gains realised on non-reporting funds as well as on all capital gains on foreign assets. It was to work by allowing base cost uplift to 5 April 2017 market value, providing relief for individuals (who were not FDRs) who became long term resident for the first time in 2017/18 provided they met certain other conditions (see our January 2017 Update Reforms to the Taxation of Foreign Domiciliaries for the conditions).
- A special cleansing relief was to come in for all foreign domiciled individuals (apart from FDRs) with mixed fund bank accounts (again see our January 2017 Update Reforms to the Taxation of Foreign Domiciliaries for the details).
- Protections were to come in for settlor-interested trusts where the settlor was a long-term resident (and not an FDR). The protections were as follows:
    - the CGT anti-avoidance provision that would otherwise automatically attribute trust gains to a UK domiciled settlor but were switched off for a foreign domiciliary would continue to be disapplied, even though the individual was deemed UK domiciled, provided the trust did not become tainted (that is, there were no non-qualifying additions – this is a complex area and since this legislation is still overwhelmingly likely to be enacted you should discuss this with your usual Rawlinson & Hunter contact to make sure you do not inadvertently taint your trust and lose valuable protections).
    - broadly the foreign income tax anti-avoidance legislation that would subject the settlor to a tax charge on the trust income as if it were his own was to be repealed. This would have been very helpful, as it would have meant that the trustee (who was a "relevant person" in connection with the settlor) could have used the funds in the UK without resulting in a taxable remittance for the settlor. Again, tainting would cause a loss of the protection so advice should be taken.

A limited number of relaxations to Business Investment Relief (BIR) were introduced in the Finance Bill 2017 published on 20 March 2017, to have effect from 6 April 2017 to encourage greater investment in the UK. These, summarised briefly below, have also been withdrawn.

- The "extraction of value" rule was to be modified. The "involved company" definition 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 was to be narrowed by the removal of the reference to "involved company".
- A new hybrid company category was to be added to the list of qualifying investments for BIR purposes. This was to enable a company that both trades and is a stakeholder company to qualify. Under current provisions 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 was to be increased from two to five years.
- The relief was to 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 his or her funds to avoid being taxed on the remittance) was to 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.

It should be noted that the 20 March 2017 Finance Bill did not include the following anti-avoidance provisions that appeared in the draft December legislation and/or the HMRC/HM Treasury Response Document published at the same time. Our January 2017 Update Reforms to the Taxation of Foreign Domiciliaries provides details about what was published in December 2016.

In the end it was decided that more time was required to work on the legislation and the provisions were dropped, with the suggestion that they would be refined and introduced in a subsequent Finance Act. We commend the Government, HMRC and HM Treasury for this decision. Broadly the dropped provisions were:

- Under the settlements regime (income tax anti-avoidance regime) the benefits charge for the settlor and close family members of the settlor.
- The re-cycling rule under the CGT anti-avoidance provisions and two Income Tax anti avoidance codes, intended, broadly, to prevent avoidance of UK tax through trust distributions to beneficiaries who are not taxable in the UK on the distributions, but who then make onward gifts to individuals who would have been taxed in the UK.
- Transfer of the CGT attribution benefits charge to the settlor where the beneficiary is a close family member who is not taxable on the benefit.
- Various CGT anti-avoidance provisions intended to prevent the washing out of trust gains through payments to migrating beneficiaries and non-UK residents.

The impact on those who were to become deemed domiciled under the changes

As mentioned above, we consider that the most likely outcome is that all the previously anticipated changes will still be effective from 6 April 2017, just as the 20 March 2017 Finance Bill stated. In that event, in the final analysis there would be no actual impact, just the irritation of the uncertainty now until the position has been clarified later in the year.

A deferral of implementation until Finance Act 2018 would allow the proposals discussed above, which were dropped from the 20 March 2017 Finance Bill, to be enacted at the same time. However, this is a remote possibility and a 6 April 2017 start date has to be assumed until we are given a reason to believe otherwise. We will update this publication if there is anything of relevance in the party manifestos but it seems likely that we will not know anything more until after the General Election (8 June 2017).

FDRs

The provisions relating to FDRs were the most penal of all the proposals and, in consequence, the part where there is perhaps least possibility of a softening or policy change. Anyone who has embarked on a strategy to leave the UK, so as to avoid being caught by this legislation, should not come back to the UK simply because they have been dropped from the initial Finance Act. We will know what the position for the 2017/18 tax year is in the Autumn and issue an update at that time.

Long-term resident

Whilst less penal in nature than the FDR proposals, it is still likely that this legislation will pass with effect from 6 April 2017, so that an individual who has been UK resident in 15 or more of the preceding 20 tax years will become deemed domiciled from that date. Accordingly, someone who from an IHT perspective is not deemed domiciled under the old 17 out of 20 rules but would be under the “15 out of 20 preceding” 2017/18 tax year rule should not now establish a trust. If, as we expect there is a Finance Act (No 2) 2017, which enacts the provisions as they were in the 20 March 2017 Finance Bill, establishing the trust would result in a tax liability and the trust would not be able to qualify for protected status.

Transitional provisions and reliefs

Individuals may, placing reliance on the various statements made and, most particularly on the 20 March 2017 Finance Bill 2017, have taken steps already with respect to the cleansing of mixed accounts, and also taken advantage of the anticipated CGT rebasing and Business Investment Relief changes. In addition Trustees may have carried out transactions since 6 April 2017 relying on the income tax protection afforded by the fact that foreign income would no longer be seen as belonging to the settlor.

Regardless of what changes might go through in a second Finance Act which follows the General Election (a new Government not being bound by the old one) it is to be hoped that, since in a number of cases there will be clear financial detriment, whichever Government is elected will enact measures to protect taxpayers who have already carried out transactions with a legitimate expectation of availability of the reliefs and protections set out in the 20 March 2017 Finance Bill. To do otherwise is clearly unfair to the affected persons.

Rebased assets

Individuals becoming deemed domiciled as long-term residents on 6 April 2017 were expected to be able to calculate gains realised on or after that date on foreign assets by replacing the original acquisition cost with the open market value of the asset as at 5 April 2017, where this was higher.

Where a disposal has already been made since 6 April 2017, it is likely that rebasing relief will still be available (if all the conditions that were in the 20 March 2017 legislation were met). However, we would suggest that if the proceeds of the sale are still outside of the UK, it would be a sensible precaution if they remain there until we know more about the reintroduction of the legislation.

Where a sale has not taken place, but a sale is now contemplated in circumstances where the availability of the 5 April 2017 rebasing is essential, it may be sensible to defer the disposal until it is absolutely clear that the rebasing will be introduced as originally set out in the 20 March 2017 Finance Bill. If you are in this situation, please contact your usual Rawlinson & Hunter partner since careful consideration of all the facts is necessary.

Cleansing of mixed funds

These provisions were designed to offer an opportunity to segregate mixed funds into their component parts (or at least those parts that could be identified) by way of “cleansing” transfers to other accounts, to enable a more tax-efficient remittance of cash to the UK. They were to be available to any foreign domiciled person (whether UK resident or not) other than a FDR.

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 that 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 dropped cleansing provisions would have allowed for segregation of a mixed fund provided the re-arrangement occurred:

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

There were other conditions that needed to be met to qualify for cleansing as set down in our Update Reforms to the Taxation of Foreign Domiciliaries.

Where a cleansing exercise has already been carried out but there have been no remittances to the UK, we would advise that no remittances are now made until it is known for certain what the position will be. As stated above, we do think it highly likely that cleansing will be enacted with effect from 6 April 2017 but we cannot absolutely guarantee this, so any transfer to the UK would carry a degree of risk. If funds from a cleansing exercise have been brought into the UK already, then nothing can be done to reverse this so it will be necessary to await confirmation in due course that the provisions set down in the 20 March 2017 legislation will apply effective from 6 April 2017 and the exercise had the consequences anticipated when it was carried out.

Where no cleansing exercise has been carried out yet, we can of course carry out the preparatory work but there is a possibility (albeit very remote in our view) that the legislation will not be enacted. As such, clients will need to consider whether they want to incur the cost of the work when there is a small risk that they might not benefit from it (or at least not benefit as much as they had hoped to).

Given the paralysis that removal of the cleansing provisions from the initial Finance Act has resulted in, it would seem fair to extend the cleansing window by a year so that it runs from 6 April 2017 to 5 April 2020. Representations will be made.

Trusts and the income tax protection provision

Offshore trusts are “relevant persons” in connection with their settlors. This discourages trustees from using trust income in the UK, if the income is deemed to be income of the settlor under the income tax anti-avoidance provisions, since to do so would result in an income tax liability on a deemed remittance by the settlor. To promote investment in the UK (amongst other things) one of the Finance Bill 2017 changes (which was dropped) switched off both sets of income tax foreign anti-avoidance provisions such that foreign income was no longer seen as the income of the settlor. This meant that the settlor would only be subject to tax when he or she received a benefit. It would also mean that the trustee could use the income for UK expenditure without it being a remittance. Trustees may well have been doing this since 6 April 2017 and if the legislation is not passed and backdated, it will be unfortunate as inadvertent remittances may have arisen.

Where transactions have already taken place, nothing can be done to reverse what has already happened. However, whilst there is uncertainty, looking to history we would expect the pattern of previous General Election years to be followed with there being a Finance (No 2) Act 2017 (for comparison 2015 had two Finance Acts and 2010 had three).

We would expect the foreign domiciliaries legislation to be in the Finance (No 2) Act 2017 and effective from 6 April 2017. Provided this is the case, the settlor will not suffer tax as a result of the actions taken by the trustee earlier in the tax year.

However, to be cautious, until we know more about the reintroduction of the legislation, for future transactions the trustees should revert to the position under the current law (that is, foreign trust income deemed to arise to the settlor should not be used by the trustees for UK expenditure).

Business Investment Relief

As mentioned in the overview, a limited number of changes to BIR were to have been included in Finance Act 2017, to have effect from 6 April 2017. Transactions may have been entered into relying on the 20 March 2017 Finance Bill legislation. As with everything else where actions in reliance on the announced rule changes have already been taken, they cannot be reversed. It is going to be necessary to await confirmation in due course that the provisions set down in the 20 March 2017 legislation will apply effective from 6 April 2017 and that the actions had the consequences anticipated when carried out.

For impending transactions, however, we recommend adherence to the conditions of the more stringent current law or waiting to make the investment until your Rawlinson & Hunter contact advises you it is safe to go ahead.

Extending IHT to Enveloped UK Residential Property, Relevant Loans and Collateral on the Relevant Loans

There was significant activity in the run up to 6 April 2017 to "de-envelope" UK residential property from offshore company structures. Where, for whatever reason, de-enveloping was not possible before 6 April 2017, it has been carried out since or in many cases is still under consideration. The following factors are relevant currently:

- the various tax costs of dismantling the structure;
- recognition that liability to the Annual Tax on Enveloped Dwellings (ATED) and ATED-related CGT (with no main residence relief) continues to accrue if the structure remains;
- but acknowledging also the remote possibility that the dropped legislation will not be reinstated (or at least not reinstated this tax year) and there may be no IHT if the property is kept within the structure.

If a foreign domiciliary is elderly or in poor health it would certainly seem sensible to defer de-enveloping until more is known.

For others, the on-going ATED exposure and possible house price increases will need to be factored into any decision as to whether to proceed with de-enveloping or await clarification on the reintroduction of the legislation.

The present position could lead to unfortunate situations. To provide an example, if an individual who is a foreign domiciliary dies now owning the shares in a foreign company that just owns a UK residential property, the current rules apply and it is excluded property which is exempt from IHT (the company being a blocker). The 20 March 2017 rules that have been dropped cannot presently be applied. If Finance Act (No 2) 2017 enacts the legislation, back-dating it to 6 April 2017, the Executors would then find that an asset which was exempt from IHT under the law in force at the date of death has retrospectively become chargeable, an extraordinary scenario (although the start date for these changes was announced as far back as Summer 2015, so taxpayers did know that it was happening).

To conclude

The announcement of a Snap General Election was a surprise in general terms but, given the uncertainty for affected taxpayers, it was not expected that the provisions for foreign domiciliaries would be dropped (or at least it was thought that the majority would be kept in the truncated Finance Act). The announcement that every single provision was being dropped was a bolt from the blue (though it was reassuring that we were given to understand that the Government was committed to the policy).

On the one hand providing time for Parliamentary scrutiny has to be applauded but placing taxpayers in limbo and causing concern for those who have carried out transactions relying on Finance Bill legislation is an unwelcome consequence of this.

Ideally, we would have hoped for a clear statement that both the Government and Opposition parties recognised that taxpayers would have acted in reliance on statements made and on the contents of the 20 March Finance Bill 2017. Such a statement might also have confirmed that whichever party or coalition formed a Government after the General Election, a second Finance Act would be enacted in the year which would at least protect the position of taxpayers who had acted with a legitimate expectation that these provisions would become law. The lack of such a statement exacerbates taxpayer uncertainty.

RAWLINSON & HUNTER

Eighth Floor
6 New Street Square
New Fetter Lane
London EC4A 3AQ

And at

Q3, The Square
Randalls Way
Leatherhead
Surrey KT22 7TW

T +44 (0)20 7842 2000
F +44 (0)20 7842 2080
firstname.lastname@rawlinson-hunter.com
www.rawlinson-hunter.com