**Summary of UK tax changes coming into force from 6 April 2017**

In the Summer Budget 2015 it was announced that there would be significant changes to the way those who were not domiciled in the UK and living in the UK long term would be taxed.

Whilst there are still certain areas that remain unclear, it appears that the UK Government are still insistent that any changes to the legislation will take effect from 6 April 2017, giving many people a short window within which to arrange their affairs. Draft legislation was issued on 5 December 2016 with a suggestion that further legislation should be available by end March 2017 to deal with one or two areas that have not been fully addressed. This is clearly an undesirable state of affairs but unfortunately one that we are forced to accept.

The aim of this note is to give you a high level view of the intended changes. Further discussion will follow. It is important that you also seek advice specific to your own circumstances before taking any action.

This note covers two basic aspects of the proposed reform. The first being the change in domicile rules and the second being the impact on the treatment of trusts that (a) have UK property and (b) have UK resident or indeed deemed domiciled beneficiaries; whether these are the settlors themselves or other family members.

**Basic details of the reforms**

As previously announced, those who live in the UK long term will be classed as deemed domiciled in the UK from 6 April 2017. For these purposes, long term is where an individual has been UK resident in any 15 out of the past 20 years. HMRC have confirmed that years of UK residence as a minor (i.e. before the age of 18) will count for these purposes.

In addition, those who were born with a domicile of origin in the UK and return to live in the UK, will be deemed domiciled for income and capital gains purposes from the first tax year they are resident in the UK after 5 April 2017. A short grace period of one year will be available for inheritance tax purposes.

The proposed reforms have not been watered down after the Brexit vote and the following appointment of a new Chancellor which means that the fundamentals of the original consultation in 2015 remain intact.

The BIG change of note is that at present those not domiciled in the UK can elect to be taxed on the remittance basis so that foreign income and gains are only taxed if they are brought into the UK. Being deemed domiciled will mean that individuals are treated in many respects identically to any UK domiciled individual. This means that they will be taxed on an arising basis on worldwide income and gains for any tax year they are UK resident, regardless of whether that income/gain is brought into the UK. NOTE that the way residence is calculated can mean that a client can be deemed domiciled earlier than some may anticipate.

It also means that from a UK inheritance tax perspective, foreign assets may fall into the inheritance tax net earlier than anticipated under the current rules. There is also reform around trust structures that hold residential property which will potentially impact on an individual's IHT position.

**Transitional reliefs**

There are some transitional reliefs confirmed in the new consultation which will only apply in certain circumstances. However, there are two reliefs which will be of wider interest:

1. *Rebasing of foreign assets for capital gains tax purposes*

HMRC recognizes that to tax gains arising on foreign assets held before 5 April 2017 to those becoming deemed domiciled on that date would be unfair and therefore have introduced a rebasing protection. This will allow individual foreign assets to be rebased to their market value on 5 April 2017 for the purposes of capital gains computations.

There are a number of restrictions to the protection:

- It only applies to assets which were foreign situs at 8 July 2015
- Those who become deemed domiciled later than April 2017 will not qualify for any rebasing
- Those who become deemed domiciled because they were born in the UK with a UK domicile of origin will not qualify for any rebasing

2. *Offshore bank accounts containing foreign income and gains*

A further relief is being made available for those becoming deemed domiciled who have complicated mixed funds which should enable them to cleanse their accounts. A temporary window of one year to 5 April 2018 is being introduced to allow these mixed funds to be separated into clean capital, foreign income and foreign gains. This will prevent punitive tax charges arising on remittances from the clean capital pot in the future. This special window will only apply to funds held in banks and similar accounts. It also requires that the individual can track the source of their original funds in order to separate them.

Some clients may well now want to reconsider their status within the UK and leave; for those clients it was originally thought that a deemed domiciled individual would be required to be non-UK resident for 6 complete tax years in order to lose their deemed domiciled status. HMRC have acknowledged that there was no policy intention to lengthen the time it takes to become non-domiciled and have therefore confirmed that deemed domiciled status will be lost after 4 years of non-UK residence. However, individuals looking to reset their domicile clock and return to the UK will still be required to remain non-UK resident for 6 years.

No transitional reliefs will be put in place for those who have already left the UK in reliance on the current rules.

**Inheritance Tax Changes**

Turning now to the changes to the scope of the charge to IHT.

The proposed changes are intended to ensure that the value of UK residential property held through non-UK corporations is subject to UK inheritance tax. At present (and until 5 April 2017), non-UK corporations change the situs of property for inheritance tax purposes, from being UK property, which is subject to inheritance tax in the hands of an individual owner or the hands of a trustee owner irrespective of their residence or domicile position, to non-UK property, which is not subject to inheritance tax (as "excluded property") in the hands of a non-UK domiciliary (until they have been resident in the UK for a period exceeding 16 years in any period of 20 years) or trustees of trusts settled by non-UK domiciliaries.

Since April 2013, there has been discouragement of the use of non-UK corporations to own residential property in the UK. This was initiated through the enactment of the Annual Tax on Enveloped Dwellings (ATED) regime, which imposes an annual charge to tax based on the value of residential property held through corporations initially starting with the properties worth in excess of £2m but now applying to all properties with a value of more than £500,000. At the same time, ATED-related capital gains tax was introduced to subject corporations holding residential real estate within the ATED regime to capital gains tax on the value over and above the April 2013 value on a later disposal of the property.

The main remaining benefit of such structures was inheritance tax mitigation and this is likely to be removed with effect from 6 April 2017 absent a significant about face by the Government.

All of these changes taken together mean that it is unlikely to be attractive for individuals or trustees to hold new acquisitions of UK residential property through non-UK corporations in the future. Similarly, in a number of cases it will no longer be tax-efficient to hold existing properties through structures as at present. Removing such properties from corporations (a process known as "de-enveloping") is likely to be a priority, if it can be done without significant tax cost (which is not always the case, particularly where there is a trust involved).

The new regime will apply to residential property held in the UK through non-UK corporations which are closely held (meaning controlled by five or fewer participators – broadly, shareholders).

In most cases, the question of what constitutes residential property for these purposes will be straightforward, although the consultation debates the finer detail of how "residential property" should be defined. Whatever approach is ultimately taken, it is clear that unlike ATED the extended inheritance tax regime will apply irrespective of the value of the property (so there will be no "cut off" for properties worth less than £500,000) and it will apply irrespective of whether the property is vacant, occupied by the beneficial owner of the non-resident corporation or indeed let to a third party. We should therefore expect any final legislation to be very broad and will apply to all residential property.

Whilst the Government are looking to allow certain exclusions where residential property is converted to commercial property, any exemptions are likely to be few and far between.

Likewise, the consultation document addresses the (somewhat common) scenario where the property in question has a mixed use. For example, a commercial property may be owned which contains a small flat. In that case, the proposal is that the value of the flat should be assessed independently of the commercial property on a just and reasonable basis.

The manner of the charge is somewhat complicated. Whilst the charge is based on the value of residential property, the existence of the company cannot simply be ignored. The legislation deals with this issue by taxing the shares in the company to the extent that their value is attributable to the value of the UK residential property (but not the value of any other property owned by the company). This also means that the shares may be worth less than the actual property (for example, because the shares are less easily marketable than the property itself).

As part of the original consultation process HMRC indicated that 'connected party debts' would be disallowed in dealing with the valuation of UK properties. The draft legislation deals with this in a subtle way. It means that in certain circumstances the value of the debt will be deductible in valuing the UK property but the corollary to this is that the value of the loan will be deemed to form part of the donor's estate, or the donor's trust in which he or she retains an interest. This has a wide implication as there is a possibility that certain loans may be subject to double tax, or single tax and no deduction, for example where the loan is made from a settlor interested trust as there are anti-avoidance provisions which deny a deduction for a loan which is made out of assets previously given away by the taxpayer.

The legislation also contains its own targeted anti-avoidance rules. This will enable HMRC to disapply any arrangement which has as its sole or main purpose avoiding or mitigating a charge to inheritance tax on UK residential property. Again, it should be noted that succession planning can occasionally have inheritance tax benefits but the current documents do not cover this in any detail.

There is a clear problem with collecting tax where the owner of the property, the value of which is to be assessable to tax, is a non-UK corporation. The Government intends to address this by extending responsibility for reporting to HMRC when chargeable events have taken place and for paying any tax which arises. Any person that has legal ownership of the property, including the company itself and, crucially, any directors of that company, will be personally liable for any outstanding inheritance tax. The inheritance tax legislation in any event contains little-used provisions which enable the inheritance tax liability to follow the property in certain circumstances. We expect that one of the questions to be included in the standard pre-contract enquiries will be to check whether any inheritance tax is owing on the property, under the new regime.

There will be no tax reliefs on de-enveloping (i.e. SDLT or CGT) and this may result in significant charges applying in order to restructure

One point which also needs to be borne in mind is that in a settlor interested trust, the settlor can be treated as retaining a benefit in the underlying property and, as a result, the value of property will be subject to tax both under the inheritance tax ten-year charge regime (in the case of a discretionary trust) and under the reservation of benefit regime. One would think that if a non-UK company owns property and the company is held by an individual, the company could be left to a surviving spouse and the spouse exemption should apply. But what if a property is held by trustees? The spouse exemption is not generally available in such circumstances. Clients holding property through such structures will need to consider urgently how to deal with the issue.

So in summary the KEY issue for our clients with companies that hold UK properties is whether to de-envelop these and incur the attendant costs; but going forward avoid ATED and take out insurance to deal with the possible IHT liability or to leave the structures as it is and continue to pay the ATED; but either (a) take a risk that the property will be sold before there is an IHT event and/or (b) take out insurance to cover any IHT liability that will arise and where the shares (as is typically the case) are held in trust take the view that the succession plan set out within the trust terms remains an efficient method of (a) creditor protection (b) succession planning that avoids the need for a UK Will.

Where there are UK tax resident beneficiaries or where the Settlor has retained an interest in the trust then the issues become more complex.

**Other issues**

Settlor interested trusts are going to need to be looked at more closely after 6 April 2017 and actions prior to 6 April 2017 may have an impact on the beneficiaries of the trust after 6 April. (For example, where a non-domiciled individual has received a distribution from a trust outside the UK that has not been matched to prior years income and gains then future gains in the trust can match to this distribution, even, it seems, if the distribution is never remitted to the UK).

· Trusts will continue to have excluded property status for IHT purposes and therefore be protected, subject to the IHT changes for residential property.

· Trusts will continue to have excluded status for CGT and Income Tax purposes, although benefits both onshore and offshore received by settlors or closely connected family members will be taxed on the settlor. Benefits received by non-closely connected persons will be taxable on the recipient if they are UK resident.

. It will no longer be possible to wash out trust gains to individuals who are not chargeable to UK tax.

. Onward gifting strategies will need to be examined more closely and decisions may need to be taken prior to 6 April 2017 or more than three years after an individual has received a distribution for fear that the onward gift loses its current status as capital in the hands of the recipient.

In all of this, each case is unique and will need to be reviewed on its facts before taking any decisions as to how to deal with the challenges and potential pitfalls that the draft legislation presents.

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