Budget 2008 - revised rules for non-domicilaries, offshore trusts and companies

March 2008

At just 53 minutes, Alastair Darling's first Budget speech belied the 110 press releases which emerged on HMRC's website a few minutes later.

This briefing concentrates solely on the tax treatment of UK resident non-domiciliaries ("non-doms") and their offshore trusts and companies. We will be sending out further briefings shortly in relation to other aspects of the Budget.

Those who have followed the progress of the non-dom proposals since they were first announced in October 2007 will already be familiar with their broad outline. These were first set out in the pre-Budget report, significantly amended by the draft legislation and then cut back by various "clarifications" issued by Dave Hartnett, the acting head of HMRC. In this briefing we concentrate solely on further changes and clarifications introduced by the Budget. Those who want more details on the original proposals should refer back to our earlier briefings, available at **http://www.burges-salmon.com/publications/content/Residence_and_Domicile_changes_stop_press_01_08.pdf.**

We deal first with the changes affecting individuals and then look at the changes affecting offshore trusts and companies.

> *"... the changes announced in the Budget generally represent a sensible compromise and remove many of the worst aspects of the original proposals."*

Main changes

Positive changes

- Residence. Days will now count if a person is present at midnight rather than the previous proposals to count days of arrival and departure. The "in transit" rules will also be extended.
- The £1k p.a. de minimis for unremitted foreign income will be increased to £2k p.a. This is unlikely to be a signficant benefit, but may take some lower-paid non-doms out of the proposals.
- The £30k charge will be treated as a pre-payment of tax on unremitted income or gains rather than a stand-alone charge. This will benefit US citizens for whom it should now be creditable under the US/UK treaty.
- For those who have paid the £30k, remittances of up to £75k appear to be tax free: the £30k having franked the tax liability. Unfortunately, though, this £75k will be treated as the last item remitted, meaning that advantage can only be taken if all offshore income and gains for a year are remitted.
- Minor children will not have to pay the £30k.
- As previously trailed, payment of the £30k from an offshore account directly to HMRC (by electronic transfer or cheque) will not itself count as a further remittance.
- There will be a number of relaxations in the definition of "remittance", these include any of the following even if purchased using offshore income or gains:
  - artwork brought into the UK for public display
  - personal effects (clothes, shoes, jewellery and watches)
  - assets costing less than £1,000
  - assets brought into the UK for repair or restoration
  - assets in the UK for less than 9 months
  - assets already owned at 11 March 2008 even if brought into the UK after 6 April
  - assets already in the UK at 5 April 2008.
- Where income or gains are alienated after 6 April 2008, there will be a remittance if there is use or enjoyment in the UK by "immediate family" or various trust/company structures. Previously this would have applied to a wider group of "relevant persons". Adult children appear to be excluded from this definition.
- Capital losses on offshore assets may be capable of being offset against capital gains (previously the proposal was that they would be completely unallowable). However, this comes at the price of an irrevocable election and disclosure of unremitted offshore capital gains.
- Offshore mortgages. Where money is borrowed offshore, even if it is brought to the UK, until now offshore income and gains could be used to repay interest on that borrowed money. The new proposals will change this, but existing offshore mortgages in place on 12 March 2008 will be "grandfathered" (i.e. they will continue to benefit from the current rules) until 5 April 2028.

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Less welcome points

- Income whose source ceased in the past will resume its character as income from 6 April 2008. This may create significant difficulties in working out whether an item is income or capital. It had been hoped that income whose source ceased before 2007/08 would be grandfathered
- The rules on mixed funds will be "more comprehensive" than those previously announced. Unfortunately we don't have further details at this stage, making it impossible to undertake any sensible planning.
- The alienation rules will still apply to trusts and companies. It appears, for instance, that if offshore trustees pay UK advisors out of offshore income or gains, that this may constitute a remittance by the settlor.
- Double remittances. It still appears to be the case that a non-taxable remittance before 6 April may subsequently become taxable if the funds are taken back out of the UK and then remitted a second time at some point in the future.

Planning points - pre 6 April 2008

No doubt a number of planning techniques will emerge after the new rules come into force and the legislation is published. The following planning may need to be done before 6 April:

- Alienation. Gifts (e.g. to spouse) prior to 6 April appear to clean-up offshore income and gains even if subsequently remitted by the recipient. This still appears to be the case even if the remittance is after 6 April, although out of caution we would still recommend that both the alienation and the remittance should happen before 6 April.
- Previously source-ceased income. If records are not available, it may be that offshore funds should be cleared up (e.g by alienation as mentioned above) prior to 6 April.
- Those with chattels and other similar assets outside the UK (e.g. artwork, yachts, horses etc.) may want to consider bringing them into the UK before 5 April. The Budget states that these will be free of tax even if later exported and re-imported.
- Existing offshore mortgages should not be amended, extended or varied in any way - otherwise the grandfathering may be lost.

Offshore Trusts and companies

One of the worst aspects of the original proposals were the rules on the capital gains of offshore trusts and companies.

While these rules will still take effect from 6 April 2008, there has been a considerable climb-down by HMRC in a number of respects. In the following a "remittance basis user" (RBU) is a non-dom who enjoys the benefit of the remittance basis due to either:

- having income and gains of less than £2k p.a.;
- having been in the UK for less than 7 of the previous 9 tax years; or
- paying the £30k charge in the year in question.

Positive changes

- Non-UK domiciled settlors will continue to enjoy exemption from the settlor charge (s86). They will only be taxed under s87 (i.e. where they receive capital benefits from the trust).
- s87 will operate on a remittance basis. Remittances will occur if RBUs enjoy assets in the UK (e.g. occupation of a UK house) or if they receive payment in the UK or if they subsequently bring an offshore payment into the UK. The status of the RBU is looked at in the year in which the capital payment is made, not (if later) the year of remittance.

> *“... trusts will still offer considerable advantages to non-doms but detailed advice will need to be sought in each case.”*

- Interestingly, the remittance basis will apply to gains on UK situated assets as well as gains on non-UK situated assets. This is the reverse of the original proposals and will mean that trusts will still offer considerable advantages to non-doms.
- Capital gains realised before 6 April which are matched with future capital payments will not be taxed.
- Similarly, capital payments made before 6 April will not be taxed by reference to future capital gains. However, excess capital payments will only wash out future gains if made before 12 March. This is to stop large capital payments being made just before 6 April to frank future gains for a number of years to come. Excess capital payments made between 12 March and 5 April will not be taxable, but they will not enable future gains to escape tax.
- Non-resident trustees will be given the opportunity to make a general re-basing election. This is the most positive aspect of the new proposals and will mean that gains accrued (but not realised) up to 5 April can escape tax. We look further at this below.
- Gains and capital payments will generally be matched on a last-in first-out (LIFO) basis. This reverses the present first-in first-out (FIFO) rules and will apply to all non-resident trusts (whether or not for non-doms). This will generally be welcome, although it means that gains made after 6 April will be matched first, potentially delaying access to the gains made (or elected to be made) under the old rules.

- The proposed notification requirement for existing offshore trusts will be removed. Furthermore, there will be no automatic notification requirement for new offshore trusts. However, UK resident non-dom beneficiaries must still disclose sufficient information to enable their tax returns to be properly completed.
- The rules on offshore income gains have been clarified to prevent double charges.
- The rules on schedule 4C gains (transfers of value linked with trustee borrowing) will broadly follow the above treatment.

Offshore companies

The above rules will apply to offshore companies owned by offshore trusts (i.e. two-tier structures). However, they will not apply to stand-alone offshore companies, the rules for which will be broadly those announced in the draft legislation. This potentially puts stand-alone offshore companies in a worse position.

Rebasing election

As mentioned above, one of the most positive aspects of the Budget changes is the ability to make a general rebasing election. In many but not all cases this will remove the need for offshore trusts and companies to undertake restructuring prior to 6 April. However, there are some circumstances where this will not be the case which we come back to below. The following points should be noted:

- the election is a once-for-all election and will apply to all assets held at both trust and subsidiary company level;
- the election will not, though, apply to stand-alone companies;
- the election can be made by all non-resident trusts (irrespective of the domicile of the settlor or beneficiaries), but will only have effect for s87 purposes, and will only benefit non-domiciled beneficiaries. In other cases it will be neutral;

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- the election deems there to be a reacquisition on 6 April 2008, but it does not deem there to be any disposal. It is only when each asset is subsequently disposed of that the election takes effect;
- there is a considerable period of grace in which to make the election. It does not need to be made until 31 January 2010 or, if later, 31 January following the tax year in which a calculation first needs to be made (either because a beneficiary has received a capital payment or because part of the trust is transferred to another trust);
- strictly there will be a single pool of gains for s87 purposes. However, the rules can best be thought of as creating two separate pools (pre and post 6 April 2008), albeit that gains will not enter the pre 6 April pool until an actual disposal is subsequently made;
- there are some detailed transitional rules governing the interaction of these "two pools" with capital payments made in the transitional period between 12 March 2008 and 5 April 2008. In practice these are simply to stop excess capital payments being made within the next few weeks. They appear to achieve this job;
- making an election is likely to require the trust to give up any confidentiality.

Should those who are currently restructuring continue, or is the rebasing election preferable?

Our general view is that the rebasing election has been well thought out and will generally be preferable (and obviously cheaper to implement) than an actual restructuring.

However, there are several circumstances where this will not be the case and actual restructuring before 6 April will remain preferable:

1. Stand-alone companies. As mentioned above, the election is not possible for them.
2. Situations where a company might become stand-alone. This would apply, for instance, if a company has already been (or is in the process of being) transferred to beneficiaries.
3. Situations where some assets are standing at a gain and others at a loss. Because the election is all-or-nothing actual restructuring may continue to be preferable.
4. This might apply, for instance, where minority shareholdings in private companies are concerned. Such shareholdings may have a market value lower than their pro-rata value due to the minority nature of the shares.
5. Structures which own UK houses occupied by beneficiaries. It is still worth restructuring here because the benefit of living in the house will be a capital payment received in the UK.
6. Situations where there is a danger that the beneficiary's domicile may subsequently change. In this case it will be preferable to restructure the assets and make capital payments to the beneficiary before 6 April 2008.
7. There may be some limited confidentiality advantages in actual restructuring, although given that the election does not need to be made until the first taxable event, this seems to us to be a limited advantage.

In most other cases the position is broadly neutral. However, in the following cases, actual restructuring could be worse than the election:

- where the trust might lose its excluded property status for inheritance tax;
- where the restructuring might trigger Stamp Duty Land Tax or Stamp Duty Reserve Tax;
- where there are both domiciled and non-domiciled beneficiaries. Actual restructuring will start the "supplementary charge" running immediately whereas the election will not start it until the subsequent actual disposal of those assets;
- if there is any doubt that liquidation of a company might not complete before 6 April. The loss of the ability to make an election may mean that this becomes a positive disadvantage;
- if surplus capital payments are made to a non-dom beneficiary whose domicile status subsequently changes, then the previous payment may continue to be matched with future gains - even if the payment is before 6 April 2008. This has always been the case, but needs to be remembered in actual restructurings.

Planning ideas

- All trustees need to consider now whether to proceed with actual restructuring or to consider making an election at some point in the future. If the latter, the actual making of the election can be deferred.
- Offshore trusts will continue to offer advantages to non-doms when compared to personal ownership. This is largely due to the remittance basis for UK assets.
- Where offshore assets owned personally are currently standing at a gain, it may well be worthwhile setting up a new trust before 6 April to rebase these. The IHT position would need to be watched, however.
- A further advantage of trusts is that they can realise gains over a number of years and then make capital payments in a single year - therefore enabling the £30k charge to be paid only once.
- Trusts may wish to consider drip-feeding £2k per annum to non-doms who have no other offshore income or gains.
- It may be possible to transfer stand-alone companies to trusts before 6 April in order to allow them to benefit from the rebasing election.
- For the future, it may be better to have a number of parallel trust structures rather than a single large trust due to the way in which the LIFO rules will tax newer gains first.

Conclusion

While the overall proposals are clearly worse than the present position, the changes announced in the Budget generally represent a sensible compromise and remove many of the worst aspects of the original proposals. It will still be prudent to review all structures prior to 6 April, but in many cases the automatic rebasing election will allow a more measured view to be taken over a longer period. Going forward, trusts will still offer considerable advantages to non-doms but detailed advice will need to be sought in each case.

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