# FOREIGN DOMICILIARIES – WHERE ARE WE NOW?

BRIEFING

November 2017

## Introduction

Our October 2017 Briefing summarised the position as it was at 11 October 2017 at which time:

- the September Finance Bill was progressing through Parliament; and
- the draft clauses for the December Finance Bill were being consulted upon (the deadline for comments being 25 October 2017).

This briefing provides an update taking into account Autumn Budget 2017 documents. There was no mention of the changes to offshore trusts, which will form part of Finance Bill 2017-18, in the Chancellor's Speech or the Red Book. There was, however, a short section on the changes in the Overview of Tax Legislation and Rates. The enactment of the changes in the December Finance Bill was confirmed and it was stated that following consultation the actual Bill will contain minor changes. Three specific areas are mentioned:

- Changes to ensure the onward gift rules can apply if the close family member rule applies.
- Amendments to clarify the position in the year of the settlor's death.
- Changes in relation to onward gifts to multiple recipients.

The professional bodies had significant technical concerns with the draft clauses and, whilst judgement has to be reserved until the December Finance Bill is published, an announcement that only "minor changes have been made" is disappointing.

The changes amount to the most significant package of measures affecting foreign domiciliaries since 2008. Taking both sets of changes into account, they cover the Remittance Basis, Inheritance Tax (IHT) and also fundamentally change the Income Tax and Capital Gains Tax (CGT) anti-avoidance provisions with respect to offshore trusts.

This publication provides an overview of the new regime as per the Finance (No 2) Act 2017 and the December Finance Bill 2017 draft clauses.

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## Changes effective from 6 April 2017

### Overview

The main changes that are effective from 6 April 2017 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 is 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 – is deemed domiciled for all tax purposes. Provided they are not also FDRs such individuals may be able to benefit from reliefs/transitional provisions and offshore trust protections.
3. The scope of IHT is 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, which is not made to a company, where the funds are used for the acquisition, maintenance or enhancement of an interest in UK residential property); and
    - security, collateral or guarantees in connection with the relevant loan.

The legislation has been passed so late in the tax year (Royal Assent being given on 16 November 2017) that certain IHT liabilities imposed by the new provisions with effect from 6 April 2017 may have become due and payable before the legislation imposing them became law. Acknowledging this, the Finance (No 2) Act 2017 includes specific legislation for personal representatives and trustees so that where IHT is charged or increased as a result of the amendments with the effect that the tax is already 'late':

- interest on underpaid tax will only run from the end of the month immediately following the month in which Royal Assent occurs;
- interest on an instalment payment will only run from the end of the month immediately following the month in which Royal Assent occurs; and
- the delivery date for IHT accounts due from trustees will be extended such that it runs from the end of the month immediately following the month in which Royal Assent occurs.

Effective from 6 April 2017, a limited number of relaxations to Business Investment Relief (BIR) have also been introduced to encourage greater investment in the UK.

### Reliefs/transitional provisions

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

There are, however, reliefs/transitional provisions in connection with the deemed domiciled changes for long-term residents.

The main reliefs/transitional provisions available for long-term residents are as follows:

- Capital Gains Tax (CGT) rebasing relief on foreign assets held directly by individuals, including shares and units in non-reporting funds (the gain on which is charged to Income Tax rather than to CGT).

This works by allowing base cost uplift to 5 April 2017 market value, providing relief for individuals who became long-term resident for the first time in 2017/18 provided they met certain other stringent conditions (see our Sea Change: Reforms to the Taxation of Foreign Domiciliaries Briefing for the conditions). This relief is not available for FDRs.

It is understood that rebasing applies to an individual's assets held by another under a nominee arrangement and to an individual's share of foreign situs partnership assets where the partnership is a UK partnership or a transparent foreign partnership.

- A special cleansing relief applying to the period from 6 April 2017 to 5 April 2019 for individuals with mixed fund bank accounts who have been remittance basis users in at least one tax year between 2008/09 and 2016/17 (again see our Sea Change: Reforms to the Taxation of Foreign Domiciliaries Briefing for the details). Again, this relief is not available for FDRs.

  The mixed fund provisions are one of the most complex areas in the remittance basis legislation and there are various material concerns with the cleansing legislation. Individuals hoping to take advantage of cleansing should get in touch with their usual Rawlinson & Hunter contact for specialist advice.

**Trust provisions**

New provisions for trusts which are settlor-interested and were established prior to the settlor becoming deemed domiciled are introduced. Provided he is not an FDR (the full impact of the offshore trust anti-avoidance legislation is suffered by FDRs), these provisions provide the deemed domiciled individual with protection from certain elements of the Income Tax and CGT anti-avoidance regimes for offshore settlements. The protections will be entirely lost if the trust is tainted (that is, there are non-qualifying additions after the foreign domiciliary becomes deemed domiciled – this is a complex area and you should discuss it with your usual Rawlinson & Hunter contact to make sure your trust is not inadvertently tainted and valuable protections lost).

Very broadly, the protections for deemed domiciled settlors of settlor-interested trusts prevent the settlor from being subject to tax on foreign income or any trust gains unless an income distribution or a benefit/capital payment is received. UK income arising to the trust is taxed on the foreign domiciled settlor as in prior years.

The provisions are summarised (albeit significantly simplified) in the paragraphs below.

***Income Tax Position***

In order to avoid having two different regimes, the Income Tax provisions are changed for all foreign domiciliaries, regardless of whether they are foreign domiciled or deemed UK domiciled (as long-term residents). Up until the tax year in which the foreign domiciled individual becomes deemed domiciled, additions can be made to the trust. Protection will be lost if additions are made after the individual becomes deemed UK domiciled, (though there is a transitional provision up until 5 April 2018 for adjustments/repayments to be made in connection with non-commercial loans the settlor has made to the trust).

Provided protection is not lost, the two Income Tax anti-avoidance regimes that would otherwise subject the settlor to a tax charge on the trust's foreign income as if it were his own are disregarded.

Under the new rules income within the trust is pooled, income within this deemed pool being referred to as "relevant income", and the settlor is subject to tax on benefits matched to this relevant income if the benefits are received by:

- the settlor; or
- a close family member (but only if the close family member is not subject to UK tax on it in the tax year).

Where the settlor is taxed on a benefit received by a close family member, he has the statutory right to recover from the person in question the tax he has paid.

Close family member is defined as:

a) the settlor's spouse, civil partner or cohabitee;

b) a minor child of the settlor or of someone within (a) above.

For the 2017/18 tax year, the new Income Tax charge is only imposed by the transfer of assets abroad (ToAA) legislation (the benefits charge provisions have been modified). This means that there will be no Income Tax charge if the 'motive defence' applies (broadly, where it can be demonstrated that neither the original transfer of assets to the trust nor any subsequent associated operations were motivated by the avoidance of UK tax).

Foreign domiciliaries who are not yet deemed domiciled can shelter unremitted benefits matched to income by making the remittance basis claim (the £30,000 or £60,000 remittance basis charge potentially applying, depending on how long they have been UK resident).

It was understood that the change would mean that the trustee (who is a "relevant person" in connection with the settlor) could, from 6 April 2017, use the trust's foreign income in the UK without resulting in a taxable remittance for the settlor. Unfortunately, this has not been properly captured in the drafting of the legislation. Therefore, generally segregation of income should continue and income should not be used in the UK by the trustees.

As currently drafted, there is some uncertainty over whether the changes to the ToAA legislation extend its territorial scope although it is hoped that this will be clarified. UK residents continue to be subject to tax as before (with the changes discussed above applying to foreign domiciliaries). If there is an extension to non-residents it is restricted, so there is only a tax charge on a non-UK resident settlor where relevant income (falling within the protected foreign source income definition, so arising after 5 April 2017) is matched to a benefit to the settlor or a close family member of the settlor and the motive defence does not apply. This will be discussed in greater detail in the update to our Briefing Sea Change: Reforms to the Taxation of Foreign Domiciliaries.

### *Capital Gains Tax Position*

For CGT purposes, provided protection is not lost, the anti-avoidance provision that would otherwise automatically attribute trust gains to a UK domiciled settlor in the tax year in which they are realised by the trust, but is switched off for a foreign domiciliary, will continue to be disapplied, even though the foreign domiciled individual has become deemed UK domiciled. Instead, deemed domiciled settlors will pay CGT when capital payments (these can be monetary, in specie or by way of a benefit being provided) received are matched with trust gains.

Deemed domiciliaries (who are not FDRs) continue to benefit from the FA 2008 transitional provisions relating to the offshore trust CGT anti-avoidance legislation:

- A pre-6 April 2008 capital payment matched to gains will not be taxed.
- Where the gains with which the payment is matched arose before April 2008 they will not be taxed.
- There will still be relief for gains accruing before 6 April 2008 on assets acquired prior to that date but sold after it. The relief is referred to as "rebasing" but is actually formulaic, taking

account of all assets disposed of in the tax year, so depending on what other transactions occur the amount of the relief can be diluted. As such, advice should be taken where the relief is in point. An election by the trustees has to be made for the relief to apply and there are strict time limits within which the election must be made. This is on or before the first 31 January after the earlier of: (i) a capital payment to a UK resident beneficiary; and (ii) a transfer of all or part of the trust property to the trustees of another trust. In many cases the deadline will have already passed but not necessarily, so where there is uncertainty over whether the election has been made the point should always be looked into.

Foreign domiciliaries who are not yet deemed domiciled can shelter trust gains attributed to capital payments received and retained outside the UK by making the remittance basis claim (the remittance basis charge potentially applying as set down in the commentary above on the Income Tax protections).

### *Inheritance Tax Position*

The IHT provisions with respect to offshore trusts are unchanged provided the deemed domiciliary is not a FDR (in which case after the period of grace all assets within trusts settled by the FDR will be within the scope of UK IHT whilst he remains UK resident).

Provided the trust was settled when the individual was foreign domiciled and not deemed domiciled, a trust settled by an individual who becomes deemed domiciled but is not an FDR will continue to enjoy IHT protection where the assets contained within the trust are foreign situs for UK IHT purposes. It is important, when considering whether UK IHT is in point, to remember about the extension of UK IHT from 6 April 2017 to:

- offshore companies and partnerships holding UK residential property;
- relevant loans (broadly a loan where the funds are used for the acquisition, maintenance or enhancement of an interest in UK residential property); and
- security, collateral or a guarantee in connection with the relevant loan.

## Changes effective from 6 April 2018

### Fundamental changes to the CGT anti-avoidance legislation

Very significant changes to the CGT anti-avoidance provisions are to be introduced for tax years 2018/19 onwards. The changes impact on all trust beneficiaries, regardless of domicile status, and are as follows:

- With the exception of the year in which the trust ends, capital payments provided to non-resident beneficiaries are to be disregarded for the purposes of the anti-avoidance legislation. This disregarding of payments to non-resident beneficiaries will not, however, apply where:

  a) the recipient is a close family member of a UK resident settlor and the settlor is UK resident for the tax year; or

  b) the circumstances are such that the temporary non-resident anti-avoidance provisions apply (in which case the capital payment is treated as received in the period of return to the UK).

  Where it does apply the effect of this legislation is that:

  a) the capital payment is not taken into account when computing the pools of capital gains available to be attributed to capital payments to UK resident beneficiaries; and

  b) provided that the individual is not caught by the temporary non-resident anti-avoidance legislation, gains will not be attributed to the capital payment and taxed on the individual if he becomes UK resident at a future date.

- Where a trust ends in a tax year, gains will be distributed proportionately to all beneficiaries who receive capital payments, provided there are distributions in that year to at least one UK resident and one non-UK resident beneficiary.
- A 'migrating beneficiary' is one who receives a capital payment while UK resident which cannot be matched to the trust gains pool and subject to CGT due to a deficiency of gains in the pool, but whose payment would, without the engagement of new provisions, be matched with trust gains in a later year when he has subsequently become non-resident.

  Capital payments provided to migrating beneficiaries are disregarded for the purposes of the anti-avoidance legislation (unless the recipient is a close family member of a UK resident settlor and the settlor is UK resident, or the temporary migration provisions apply). Again, this means that:

  a) the capital payment is not taken into account when computing the pools of capital gains available to be attributed to capital payments to UK resident beneficiaries; and

  b) it would suggest that provided the individual is not caught by the temporary migration legislation, gains will not be attributed to the capital payment and taxed on the individual if he becomes UK resident at a future date.
- There are special provisions covering situations where a beneficiary is only temporarily non-UK resident and where the migration is only temporary.

The rules apply to capital payments made after 5 April 2018 and also to capital payments made prior to 6 April 2018 that have not been matched to gains.

The significance of these changes is such that offshore trustees should take advice urgently, as it might be possible to take actions prior to 6 April 2018 which will be advantageous for trust beneficiaries. Those affected should get in touch with their usual Rawlinson & Hunter contact to discuss potential pre-6 April 2018 courses of action.

**CGT and the close family member provisions**

The ToAA settlor charge on benefits to close family members came in from 2017/18 onwards (as discussed above). For tax year 2018/19 both Income Tax anti-avoidance regimes and the CGT offshore trust anti-avoidance provisions will contain provisions to attribute to the settlor benefits/capital payments received by close family members (aligned definition as for the ToAA legislation above).

From 2018/19 there will be an attribution of capital gains to the settlor where:

- a beneficiary ('the original recipient') of the trust receives a capital payment from the trustees;
- the settlor is UK resident during the tax year that the payment is received; and
- the original recipient is a close family member of the settlor at the time of receipt of the capital payment.

The capital payment to the original beneficiary (the close family member) is treated as not having taken place and the settlor is deemed to have received the capital payment at the time it was made. The provision applies whether or not the settlor is a beneficiary of the trust.

As with the ToAA provisions introduced for 2017/18, the settlor has the right to recover the tax he has paid from the relevant close family member.

**Changes to the settlements' anti-avoidance regime**

For Income Tax purposes, there are adjustments to the settlements anti-avoidance regime as it relates to foreign income. The legislation is complex. In very basic terms, if a trust benefit is provided to the settlor which is not caught by the ToAA regime (typically, because the motive defence prevents the ToAA provisions from applying) it will be caught by, and taxed under, the new anti-avoidance legislation to the extent that there is undistributed income within the trust. A similar tax pool and matching concept is used to that for the ToAA legislation. As with the ToAA legislation described above, the drafting of this new provision has unexpectedly failed to disengage the 'relevant person' legislation, so that a remittance by the trustees of trust income could result in a tax liability for the settlor. Care therefore needs to be taken to avoid this happening and advice should be taken.

Rules to tax the settlor on benefits provided to close family members (defined in the same way as the ToAA legislation) are also introduced into the settlements legislation. As with the ToAA provisions, these rules are triggered where the close family member is not subject to tax on the deemed income in the tax year (as a result of being non-resident or being a UK resident remittance basis user and not remitting all or part of the benefit). Again, the settlor is entitled to recover the tax he has paid from the relevant close family member.

**Onward gift provisions**

Complicated onward gift provisions are to be introduced into the two Income Tax anti-avoidance regimes and the CGT anti-avoidance provisions. These will be explained in detail in our Briefing Sea Change: Reforms to the Taxation of Foreign Domiciliaries. Very broadly, the provisions are intended to be triggered in the following circumstances:

- a capital payment is made by an offshore trust to an individual ('the original beneficiary') who is not subject to UK tax on it (either as a result of being non-UK resident or being a UK resident remittance basis user who will not remit the payment); and
- there is an arrangement or an intention for the capital payment or anything derived from it to be passed on ('the onward payment') either directly or after a series of transfers to an individual, a 'gift recipient', (whether a trust beneficiary or not) who would have been potentially taxable (by virtue of being UK resident at the time he receives at least part of the onward payment) on the capital payment if it had been made directly to him by the trustees.

The provisions will also apply where the onward payment is made before the original beneficiary receives the capital payment if it is reasonable to assume that the onward payment was made in anticipation of the receipt of the capital payment.

The onward gift provisions apply to payments made after 5 April 2018 and do so even if the trust distribution was made before 6 April 2018.

For UK tax purposes the gift recipient will be treated as if the part of the benefit or capital payment transferred to him is matched to income or attributed to gains of the trust. If only part of the benefit or capital payment is passed on the amount that can be taxed is capped at the value received.

Special provisions mean that the settlor may be subject to tax if he is a gift recipient and/or a close family member (or members) are gift recipients. Again, the CGT provisions are the widest. Where the settlor is taxed as a result of any of these provisions he has a right to recover the tax from the relevant close family member.

**And finally**

The UK tax regimes which apply to foreign domiciliaries and offshore trusts were extremely complicated before these changes, and now the complexity has been taken to an altogether new level. The significance of the changes has been highlighted above.  Affected individuals and offshore trustees should take specialist advice as soon as possible. Your usual Rawlinson & Hunter contact would be pleased to assist.


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