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Double act: what the two forthcoming Finance Acts will mean for non-doms and beneficiaries of non-resident trusts

25 September 2017

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Hot on the heels of the Finance (No.2) Bill 2017, the government has released a draft Finance Bill 2018-19. This re-introduces some of the complex anti-avoidance provisions regarding trusts that were dropped from the original Finance Bill 2017 in March. Although these provisions will be unwelcome to many, there is at least now sufficient certainty regarding the future regime for the taxation of non-resident trusts to allow trustees and beneficiaries to start planning with more confidence.

Overview

A new Finance Bill 2018-19 has recently been published, less than a week after the release of the Finance (No.2) Bill 2017. The latter will now, subject to any minor changes following parliamentary scrutiny, become the Finance (No.2) Act 2017. Its provisions will apply retroactively from 6 April 2017.

The Finance Bill 2018-19, on the other hand, is expected to apply from 6 April 2018. This new Bill confirms the UK government's intention to put in place various anti-avoidance provisions regarding non-resident trusts, including a reformulation of the widely-feared "anti-recycling" rules.

Finance (No.2) Bill 2017

The draft legislation concerning foreign domiciliaries contained within the most recently published version of the Finance (No.2) Bill 2017 is almost identical to the previous iteration, which was released in July 2017. This is disappointing, as it still contains various technical defects, which have been brought to the Treasury's attention by professional bodies but have not been remedied.

By way of reminder, the key provisions, which will take effect retrospectively from 6 April 2017, are as follows:

- *Deemed domicile*

  A non-UK domiciled individual will now acquire a deemed UK domicile for <u>all</u> tax purposes once he or she has been UK resident for 15 out of the previous 20 tax years. This means that the remittance basis of taxation will normally cease to be available to non-UK domiciliaries from their 16th tax year of UK residence.

  The rules are much stricter for the small class of non-UK domiciliaries who were born in the UK with a UK domicile of origin (so-called "formerly domiciled residents" or FDRs). Generally, such individuals will become deemed domiciled from their first tax year of UK residence.

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- *Non-resident trusts: "protections" and "tainting"*

  Non-resident trusts will become even more attractive as asset-holding vehicles for foreign domiciliaries (except FDRs). Trusts created by foreign domiciliaries will typically have a privileged tax status that will allow tax to be deferred on non-UK income and gains, without any requirement for the settlor to pay the remittance basis charge, and even after the settlor has become deemed domiciled due to long-term UK residence. However, this privileged status will be lost if there is a "tainting" event. "Tainting" of the trust will occur, very broadly, if there is an addition of property to the trust by the settlor or a related trust, following the settlor's acquisition of a deemed UK domicile due to long-term residence in the UK.

- *Valuation of benefits*

  Statutory rules regarding the valuation of certain benefits received from trusts will be introduced. If chattels such as artworks are made available to a beneficiary, the benefit received will be calculated using the HMRC official rate, multiplied by the acquisition cost of the chattels. The official rate will also be used to determine the value of an interest-free loan, and no account will be taken of any rolled-up interest on a loan.

- *Rebasing and cleansing*

  Two reliefs will be introduced:

  - A capital gains rebasing relief will be available whereby personally-held non-UK assets will be treated for CGT purposes as having been acquired at market value on 6 April 2017. This generous relief will be limited to those non-UK domiciliaries who became deemed UK domiciled on 6 April 2017 (excluding FDRs) and who have paid the remittance basis charge for at least one prior tax year. For individuals in this category, the relief will apply to most non-UK assets, including interests in offshore funds with non-reporting status. However, it will not affect the tax treatment of deeply discounted debt instruments or life policies.

  - A so-called "cleansing" relief will be available for virtually all non-UK domiciliaries, even if not deemed domiciled (the one exception being FDRs). The relief will provide a window of opportunity, closing on 5 April 2019, within which capital can be extracted from overseas bank accounts where the capital has become "mixed" with other sums that will give rise to tax if remitted. The capital so extracted can then be brought into the UK, without tax being triggered.

- *UK residential property*

  For foreign domiciliaries who are not deemed domiciled, the scope of inheritance tax (**IHT**) will be extended to catch indirect interests in, and other assets relating to, UK residential property. For example where a UK home is held by a non-UK company, the shares in the company will be brought within the scope of IHT. However, the IHT changes go further this, also applying to certain loans and even assets provided as collateral.

  The latest draft legislation includes transitional relief provisions to deal with IHT events occurring between 6 April 2017 and the end of the month in which the Act comes into force. They make minor adjustments to the dates on which IHT filings are required, IHT payments are due and from which interest on overdue IHT is calculated.

Finance Bill 2018-19

There are, essentially, four provisions relating to non-resident trusts that are due to be introduced from 6 April 2018. All of them featured in early drafts of the original Finance Bill 2017, but were dropped from that Bill due to constraints on parliamentary time. They will now be reintroduced, although in some cases in significantly modified form, as part of the Finance Bill 2018-19.

(1) Rules to prevent "washing out"

Where a trust has a foreign domiciled settlor, tax on trust gains is typically levied on its beneficiaries, insofar as they are UK resident. Such beneficiaries are taxed as and when distributions or other benefits are received by them. There is a notional pool of trust gains, and gains within that pool are "matched" to distributions received. If they are so matched, they come out of the pool.

Under the current law, such matching occurs regardless of whether the individual who has received a distribution is UK resident or not, although there is no tax if the individual is non-resident. Distributions to non-resident individuals therefore result in gains within the notional pool being "washed out". This may allow distributions to be made to UK residents in later tax years without gains being matched to them.

However, under the proposed new rules, the default position will be that gains will not be matched to distributions received by non-resident beneficiaries, so trust gains will not be washed out by such distributions. The new rules on this will apply to all distributions made after 6 April 2018 and to all distributions made before that date but which remain unmatched as at 6 April 2018. There are no equivalent income tax rules.

Special rules

Special rules will apply to distributions to "migrating beneficiaries", temporarily non-resident beneficiaries, and close relatives of the settlor:

- Where a UK resident beneficiary who has received a distribution becomes non-resident before the distribution is fully matched (referred to in the legislation as a "migrating beneficiary"), the unmatched element of the distribution will not subsequently be matched. Absent this rule, there would be theoretical scope for trustees to wash gains out of the trust by making a distribution to a beneficiary who is UK resident but anticipates becoming non-resident, and deferring the realisation of gains within the trust until after the beneficiary has left the UK.

- Where a beneficiary is a temporary non-resident (ie he/she is non-resident for less than six complete tax years), the distribution, or unmatched element of it, will be treated as having been made to him/her in the tax year of return to the UK, so that it will be available for taxable matching in that year or later tax years.

- The general rule that distributions are to be disregarded if made to non-residents will be switched off where the non-resident in question is a close family member (CFM) in relation to settlor. The class of CFMs comprises the settlor's spouse or civil partner and any minor children or step-children. This provision will dovetail with a further rule, discussed below, that will cause a distribution to a CFM to be treated for CGT purposes as a distribution to the settlor. The obvious aim of the latter is to tax UK resident settlors on distributions received by CFMs. It would lose much of its force if distributions to non-resident CFMs were ignored, hence the need for an exception to the general rule.

Tax year of termination

Finally, and importantly, in the tax year in which the trust comes to an end, the current rules will apply, with the result that the remaining trust gains pool will be matched to <u>all</u> distributions made to beneficiaries in that tax year (whether UK resident or not), in proportion to the sums received.

Where a trust has a mixture of UK resident and non-resident beneficiaries, this exception may make the termination of a trust in a single tax year, rather than a gradual distribution of its funds over time, more attractive. If there is a requirement to provide funding to beneficiaries in <u>prior</u> tax years, there may be advantages in such funding being provided to UK residents by way of loan rather than distribution.

(2) "Anti-recycling" rules

Background

The so-called "anti-recycling" rules seek to counter perceived abuse of the matching rules through the making of distributions followed by onward gifts. Under current law, tax on income or gains of a non-resident trust can (it is generally thought) be avoided if the trustees make a distribution to a non-taxable beneficiary (ie a non-UK resident beneficiary, or a UK resident foreign domiciled beneficiary claiming the remittance basis who leaves the distribution offshore), who then passes on the distribution to an individual who would have been taxable (by virtue of matching to trust income and gains) had he/she been the original recipient of the distribution. If the distribution is genuinely made to the non-taxable beneficiary and that individual is not under any obligation to make the onward gift, and there is no fixed arrangement that he will make such a gift, the recipient of the gift cannot be treated as having personally received a distribution from the trust.

HMRC / the Treasury see this as a significant lacuna in the tax code, and are anxious to close it. The "anti-recycling" rules are designed to plug the gap by treating the gift recipient as if he/she had personally received the distribution.

In the original draft legislation, the rules were extremely far-reaching. If enacted, they would have created a tax risk for the recipient of any gift made by a non-resident or foreign domiciled individual who in the previous three years had received a distribution from a non-resident trust – regardless of whether the gift was in contemplation when the distribution was made, or indeed whether there was any connection at all between these events. There was widespread concern that the rules would "bite" in far more circumstances than intended and would catch many gifts which were devoid of any tax avoidance purpose.

Narrowing of scope

Fortunately, the latest iteration of the draft legislation in the Finance Bill 2018-19 includes two significant and welcome changes:

- There is now no time limit for the making of the onward gift, so in theory at least, an onward gift can now be caught even if the gift occurs decades after the distribution. However, the revised rules can only "bite" if, when the distribution is made, there are arrangements for an onward gift to be made, or there is an intention to make such a gift. In addition, the rules can only apply if, when the distribution is made, it is reasonable to expect that the donee will be UK resident when he/she receives some or all of the onward gift.
- There is also a requirement that the onward gift derives from whole or

part of the distribution or, if it represents other property, that the distribution was made in connection with the onward gift. This tracing/connectedness condition significantly narrows the scope of the rules and addresses some of the concerns in relation to “innocent” arrangements involving unrelated gifts by a beneficiary.

Successive gifts

The draft rules take account of the possibility that the recipient of an onward gift could him/herself make a gift, i.e. that there could be successive gifts of property derived from a trust distribution. If the first gift recipient would otherwise potentially be taxed on a deemed distribution, but there is no tax because he/she is a non-UK resident or a remittance basis user who does not remit the sum received, the anti-recycling rules will be applied again to the second gift recipient (and so on). This means that chains of gifts from the original beneficiary to the ultimate recipient will not necessarily prevent the rules from applying.

(3) Reallocation rules

The “anti-recycling” rules outlined above are deeming rules, in that in certain circumstances they treat a gift recipient as having received a distribution although, in reality, the distribution was received by someone else. Under the proposed post-5 April 2018 regime for non-resident trusts these provisions will be accompanied by, and will operate in conjunction with, a number of further deeming rules which will, in effect, reallocate distributions for tax purposes. In certain scenarios, distributions received by a beneficiary will be reallocated, for the purposes of UK taxation, to the trust’s settlor so that it is the settlor who is potentially or actually taxed. As currently drafted, these reallocation rules can only apply where the beneficiary in question is a close family member in relation to the settlor.

The simplest of the reallocation rules is that which, it is proposed, will apply for the purposes of CGT. This says that if a CFM receives a distribution at a time when the settlor is UK resident, the matching rules for trust gains will apply as if the distribution had been received by the settlor, not the CFM. In most cases this will no doubt increase the “tax take”, but there may also be a few scenarios where this rule could work to the advantage of taxpayers.

The draft legislation also includes reallocation rules for income tax. These are superficially similar but apply only to the extent that the CFM has not been subjected to income tax on the distribution received by him/her – either because the CFM is non-resident or because he/she is a remittance basis user and the distribution has not been remitted.

In both cases, the draft legislation says that the settlor is entitled to recover tax paid by him/her from the CFM who actually received the distribution. The effectiveness of this kind of provision against a non-resident, foreign domiciled individual is extremely doubtful. That issue could become important if, for example, the trustees of a non-resident trust make a distribution to a UK resident settlor's non-resident spouse and the couple then separate.

These rules will apply in conjunction with the "anti-recycling" rules, so that if a distribution is made to (for example) a non-resident beneficiary, who makes an onward gift to a CFM, the deemed distribution to the CFM may be reallocated to the settlor. This is deeming upon deeming.

(4) Negation of the motive defence

None of this is very straightforward, but the draft income tax legislation contained within the Finance Bill 2018-19 is particularly convoluted and opaque. It incorporates provisions which seem to have been designed to impose tax on the settlor or a CFM who has received benefits from a trust by matching them to non-UK income arising at trust level, where such income has not been taxed on the settlor due to his/her foreign domicile and where, absent the proposed provisions, the motive defence would prevent such benefits from being taxed under the transfer of assets abroad code.

The detail of these provisions is beyond the scope of this note, but beneficiaries of non-resident trusts should be aware that the motive defence from the transfer of assets abroad rules, already notoriously difficult to claim successfully, may cease to shield them from tax on non-UK trust income.

Double trouble …

The impact of the changes outlined above will be widely felt. We anticipate that most non-resident trusts with UK resident settlors and/or beneficiaries will be affected, or at least potentially affected, by these forthcoming statutes, one way or the other. The message, as usual, is that tailored advice will need to be taken wherever there is a possible impact.

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