

HM Treasury - Reforms to the taxation of non-domiciles: trust protections

In the [Summer Budget 2015](#) the UK government announced a series of reforms to the tax rules for people who are not domiciled in the UK. The changes are intended for the 2017 Finance Bill.

STEP responded to the original consultation in autumn 2015 and the follow up in summer 2016. Subsequently, members of STEP's UK Technical Committee have been closely involved in discussions with HM Treasury and HM Revenue & Customs in relation to the latest proposals. (See related [blog](#)).

This draft paper sets out a potential alternative approach to legislating the trust protections.

1. Capital gains tax

- 1.1 Section 86 will not be switched on just because a DD settlor receives a benefit. S87 will be used to tax any settlor on benefits as at present but with some modifications. 2008 rebasing will be preserved for foreign doms not yet DD [and for DD].
- 1.2 Section 86 will be switched on if there is tainting after the settlor is DD. [It is for consideration whether any or all of the following reliefs should apply:
 - 1.2.1 a grace period such that inadvertent tainting can be corrected and the funds withdrawn within a certain time period
 - 1.2.2 a *de minimis* addition which can be ignored e.g. £5000
 - 1.2.3 an addition by the settlor should only taint the settlement to the extent of the addition (as per the inheritance tax position) provided records can be retained rather than taint all the settled funds
 - 1.2.4 an addition by anyone else should not lose protection for the original settlor's funds in respect of the funds he settled.
 - 1.2.5 An addition by the settlor who has become DD but lost his DD should not taint the trust.]

It was noted that the 1991 legislation on tainting caused many practical problems in commercial situations and that in the present case, unlike the position in 1991, as the settlor is DD anyway any additions are likely to be inadvertent because an inheritance tax entry charge will generally arise on such additions.

- 1.3 [It is for consideration whether an addition after settlor becomes DD also loses the income tax protections mentioned below such that the settlor is taxed on an arising basis on income as if a UK domiciled settlor.]
- 1.4 Resettlements. [to discuss – should s86 be switched on and the DD protections (income tax/capital gains tax) be lost if there is a resettlement even if there is no addition of any property but just a movement of property from one trust to another.] General view may be that resettlement after settlor becomes DD should mean the protections are lost

particularly as for inheritance tax purposes excluded property status is arguably lost by resettlement anyway. However, it may be possible to amend sub-fund provisions to ensure that if a sub-fund election is made ¹this does not lose trust protections.

- 1.5 HMRC are still considering whether all capital payments to a non-resident should be ignored for s87 purposes (in which case there is no washing out of gains but there is no charge if the non-resident comes to the UK and matching to trust gains only occurs at that point) or whether only capital payments to a non-resident beneficiary at a time when the trust has a DD UK resident settlor should be ignored. If this provision is adopted at all HMRC may favour the simple option of ignoring all capital payments to a non-resident whatever the status of the settlor unless (possibly) the trust is ended and capital payments are made to UK and non-UK residents in the same year in which case s87 gains can be allocated pro rata to the capital payment.
- 1.6 Capital payments to a temporary non-resident (whether individual or beneficiary) made while he is abroad will be taxed as under present legislation on his return to the UK. i.e. depending on his status then they will be taxed on the remittance basis if he is not DD on his return and on an arising basis if he is DD. [This is the case unless the individual left before July 2015 when some relief could be granted if he comes back after April 2017, is temporarily non-resident and would then be DD under the new legislation.]
- 1.7 Capital payments to a non-resident who is not a temporary NR but who returns before he has lost his DD will be ignored. (e.g. return after five years and a split year but before six years has elapsed.)
- 1.8 Capital payments made before [6 April 2016/July 2015] but matched to trust gains after April 2017 whether made to the settlor or any other beneficiary will be matched according to the beneficiary's status at the date of payment. This is the case even if the beneficiary is DD after April 2017 and matching to trust gains occurs only after April 2017. If the beneficiary receives a capital payment after [one of the above dates] which is matched to trust gains realised after April 2017, then it will be taxed according to his status at the date of matching. Therefore, such capital payments will be taxed on an arising basis if he is DD at the date of matching.
- 1.9 Capital payments to close family members of the UK resident settlor [whether settlor is actually domiciled here, DD or non-domiciled] will be taxed according to the status of the settlor unless the family member is already DD or actually UK domiciled in which case the family member is taxed.
- 1.10 The definition of close family members will include spouse and cohabitee [and possibly minor children and minor grandchildren.]

¹ (e.g. for foreign tax reasons or for trust reasons it may be necessary to separate out funds and treat them as separate settlements)

- 1.11 Recycling rule. Capital payments to non-close family members will be taxed on the UK resident settlor [or any other UK resident beneficiary] if at any time in the relevant period ([3??] tax years following the tax year of receipt) the property paid to the non-close family member is enjoyed by the UK resident beneficiary (whether the settlor or not) or the property paid to the family member is part of a scheme to give it to a UK resident beneficiary. The recycling rule will not apply if the non-close family member beneficiary has paid tax on the capital payment (whether on an arising basis or because the payment has been remitted). The recycling rule will apply to all UK resident settlors [as well as other UK resident beneficiaries] and the capital payment will be taxed by reference to the [beneficiary's] status in the event that the rule applies. [for discussion]
- 1.12 [Reporting of all benefits on any beneficiary's tax return even if no immediate charge arises due to the trust being dry.]
- 1.13 [Valuation of certain benefits such as art, loans etc. appropriately and on a statutory fixed basis]

2 Income tax – foreign domiciled settlors only whether or not DD

- 2.1 Section 720, 727 ITA, s624, 629 ITTOIA and [s633] will be switched off for all foreign domiciled settlors whether or not DD from April 2017 in respect of foreign income arising within trust structures including underlying companies. Such foreign income will be “protected income” and will not be taxed on an arising basis even after the settlor becomes DD [unless tainting occurs after the settlor becomes DD] but will be taxed on a benefits basis as per below.
- 2.2 Remittance of such foreign income to the UK by trust or company will therefore not result in a tax charge on the foreign domiciled settlor (whether DD or not) and trustees are free to invest in the UK without risk of remitting s731 income. Protected income will only be taxed if a benefit is received.
- 2.3 There will be no requirement to pay up foreign income within the company to the trust to avoid being taxed on an arising basis on such income. Foreign income can be retained at any level and remain protected for foreign domiciled settlors.
- 2.4 Such protected income can only be matched if “available” to benefit the settlor/or close family member. [close family member to be defined as for capital gains]. Therefore, income which is used to pay expenses, or which belongs to another beneficiary who has an interest in possession or which is distributed to another beneficiary cannot be taxed on the settlor. [note- if settlor and close family member excluded from segregated relevant income is it envisaged that they can receive benefits and not be subject to income tax? - give consideration as to what “available to benefit” means.]
- 2.5 UK source income in the company and trust will continue to be taxed on the UK resident settlor on an arising basis under s720 ITA and s624 ITTOIA. UK source income in the company which is dividended up to the trust and has already been taxed on the settlor is ignored and does not become relevant income provided the dividend paid up can be clearly identified as comprising the UK source income.

- 2.6 All foreign dom UK resident settlors whether or not DD will be subject to income tax on a benefits basis but only in respect of benefits received by the settlor or close family member after April 2017 and by reference to the settlor's status when the benefit is matched (and subject to the same point as in 1.9 above if close family member already UK dom or DD). The benefits will be matched against available relevant income and taxed according to the status of the settlor at the date of matching. The earlier remittance of s731 income by the trustees/company to the UK will not affect the tax position of the foreign domiciled settlor who will be taxed by reference to whether he remits the benefit to the UK (if not DD) or whether he has received a benefit anywhere if DD.
- 2.7 The benefits charge can arise if any benefit is received by the foreign domiciled settlor or close family member (whether provided out of income or capital) and will not apply only when the benefits are provided out of the "protected income" itself.
- 2.8 The primary matching rule will be under s731 for all foreign domiciled transferors (whether at the trust or corporate level) with s628A operating as a secondary rule where s731 is disapplied by the EU or motive defence.
- 2.9 Benefits received prior to [April 2017] will be subject to income tax (if at all) under the provisions of the current regime and otherwise matched only to capital gains as in 1.8 above. [Forestalling to be considered.]
- 2.10 All undistributed and unremitted foreign pre April 2017 income [and OIGS] will become relevant income available for matching to any benefits [including income arising before the settlor became UK resident and whether or not the benefit is paid out of the income]. Foreign income retained within the structure but remitted prior to April 2017 and therefore already taxed on the settlor will not be taxed again on the settlor if later paid up to the trust or otherwise retained and can be clearly identified as that income and this income will not form part of the pool of relevant income.
- 2.11 [Income paid out as it arises or within the following tax year will not be relevant income and will be taxed as income on the settlor according to his status at date of receipt.]
- 2.12 Any income matched under the transfer of assets abroad provisions will reduce the pool of protected income which can be matched under ITTOIA s 628A. Similarly, income matched under s628A cannot be relevant income for s731 purposes in future years (e.g. if the motive defence is lost). Income paid up from company to the trust will not be regarded as a new source of protected income provided it can be clearly identified as paid out of the income of the company. i.e. no double counting.
- 2.13 Matching will be on a last in, first out basis.
- 2.14 Where the benefit received is matched to income which can clearly be identified as income on which the settlor has or will pay foreign tax then the settlor will be entitled to the same tax credits/reliefs as if he had received the income directly.
- 2.15 No washing out of protected income on payments to non-residents (unless temporarily non-resident).

2.16 Recycling rule as in 1.11 above.

STEP UK Technical Committee

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