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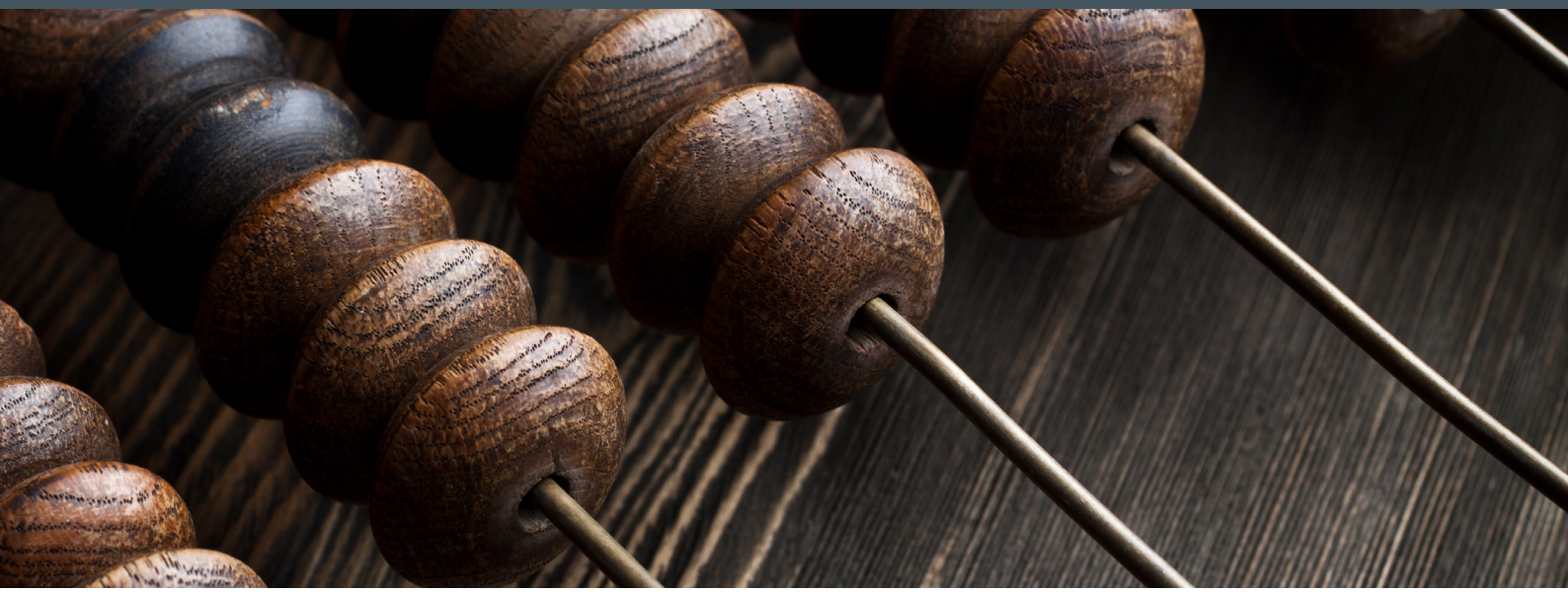

Changes to the taxation of non-UK trusts Round Two

September 2017

It has been more than two years since the government launched the most far-reaching review of the taxation of non-UK domiciliaries since 2008. The proposals included reforms to the deemed domicile rules, changes to the inheritance tax treatment of UK residential property-holding structures, and anti-avoidance measures affecting the tax treatment of non-UK trusts.

The period since then has been marked by delays and uncertainty, including a postponement because of the snap general election. It was originally intended that all of the new rules would take effect from 6 April 2017. However, in March it was announced that they would be introduced in two stages: a first set of changes would take effect as planned on 6 April 2017, while the remaining measures would be deferred to allow more time to consider the detail.

Over the last two weeks, greater certainty has emerged.

- On 8 September, legislation was published confirming the changes taking effect on 6 April 2017. This legislation is expected to receive Royal Assent in November.

- On 13 September, the government published a substantially re-written version of legislation first released last year, and announced that this would be introduced with effect from 6 April 2018. The revised clauses are now subject to consultation until 25 October 2017.

In this briefing, we recap on the changes being introduced from April 2017, and summarise the main aspects of the provisions that are expected to apply from April 2018.

Changes taking effect from 6 April 2017

We reported on these in our July briefing.

The headlines are:

- the introduction of a new deemed domiciled status for individuals who have been UK resident in 15 or more of the previous 20 tax years;
- "rebasing" of non-UK assets held by individuals becoming deemed domiciled under the new rules to their value as at 6 April 2017;
- a two-year window in which remittance basis users can separate the different elements of mixed funds held in bank accounts;
- the disapplication of the income tax anti-avoidance rules which attribute non-UK source income arising within a trust to a UK resident settlor (the "protected settlement" regime);
- the introduction of rules that attribute income to a UK resident settlor of a non-UK trust where a benefit is received from the trust by a "close family member" who is not subject to tax on that benefit; and
- the removal of the inheritance tax benefits of holding UK residential properties through non-UK structures, in particular non-UK incorporated companies.

It now seems likely that the legislation enacting these proposals will be introduced in the form published two weeks ago. This will be a relief to those who, relying on the original announcement that the new rules would take effect on 6 April 2017, reorganised their financial affairs and asset-holding structures in anticipation - in many cases, making significant changes.

However, given the number of twists and turns so far, and the fact that draft legislation has already been pulled back from the brink of parliamentary scrutiny once, many will not relax entirely until the legislation is formally approved.

Changes taking effect from 6 April 2018

Last week, the government published legislation containing significant additions to the already complicated anti-avoidance provisions affecting non-UK trusts. The essence of these changes is not a surprise: a previous (seemingly rushed) draft of the legislation was released at the end of last year. Following a consultation in which difficult questions were raised as to how the new provisions would operate in practice, the legislation was put on hold.

The main aspects of the legislation in its re-emerged form are as follows:

Distributions to non-resident beneficiaries: "anti-cleansing" rule

The current rules

Currently, a "capital payment" (broadly, a capital distribution or non-income benefit) to a beneficiary may be subject to capital gains tax in the beneficiary's hands by reference to gains realised within the trust. This is known as "matching". Once trust gains have been matched against a capital payment, they cannot be matched against other capital payments (so double counting is avoided).

Capital payments may be matched against trust gains regardless of the residence or domicile of the recipient. However, those received by a non-resident beneficiary are not subject to tax. This can be advantageous, as capital payments to non-residents reduce the gains that are available to be matched with distributions to UK residents.

The new rules

The new legislation provides that, from 6 April 2018, a capital payment made to a beneficiary who is non-resident in the tax year in which the capital payment is matched will (in effect) be ignored. In other words, the trust gains that would (under the current rules) have been cleared out, will remain available to be matched against capital payments to UK residents.

This brings the capital gains tax rules applying to non-resident beneficiaries closer to the equivalent income tax anti-avoidance provisions (whereby a benefit received by a non-resident is not matched with trust income). Differences remain, however. In particular, the income tax rules are subject to a motive defence (very broadly, they may not apply where neither the creation and funding of the trust nor any "associated operation" was for the purpose of avoiding tax).

If trustees of non-UK trusts anticipate making distributions to non-resident beneficiaries, they may wish to consider doing so before 6 April 2018, particularly if there are significant unmatched gains.

Distributions to close family members: attribution of gains to the settlor

New rules will apply where a capital payment is made to a "close family member" (meaning a spouse, cohabiting partner, or minor child) of a UK resident settlor.

These were expected to follow the equivalent income tax provisions that are part of the April 2017 changes. Under the new income tax rules, if income is matched with a benefit received by a close family member, and the close family member is not liable for tax on the benefit as a result of being:

- non-resident; or
- a remittance basis user who does not remit the benefit to the UK,

the settlor will be liable for the tax as if he had received the benefit instead.

In contrast, trust gains matched with a capital payment to a close family member of a UK resident settlor will be attributed to the settlor regardless of whether the close family member is UK resident or a remittance basis user. The settlor will be entitled to claim a refund from the recipient of any tax he pays as a result.

This may or may not be beneficial, depending upon the circumstances. For example, a capital payment to a minor child of a UK resident settlor will be taxed at the settlor's rate of capital gains tax, which is likely to be 20%, whereas under the current rules the same distribution may benefit from the minor child's annual capital gains tax exemption and 10% capital gains tax band. If, on the other hand, a UK resident settlor is a remittance basis user and a capital payment is made to the settlor's spouse who pays tax on the arising basis, provided the capital payment is made outside the UK and not remitted to the UK, it will not be subject to tax under the new rules.

Distributions and onward gifts: "anti-conduit" rules

These are the most complicated of the new provisions, and the ones that have changed the most since the original draft was published. In essence, the rules are designed to address arrangements whereby:

- a beneficiary (the "original beneficiary") receives a payment or benefit (the "original payment") from a non-UK trust and is not subject to income tax or capital gains tax on that payment by virtue of being:
    - non-resident; or
    - a remittance basis user who does not receive the benefit in (or remit the benefit to) the UK; and
- the original beneficiary makes, directly or indirectly, a gift (the "onward payment") to a UK resident (the "subsequent recipient").

In these circumstances, the subsequent recipient may be subject to tax on the onward payment as if he had received it directly from the trustee.

There are detailed provisions elaborating on the basic rule. We have summarised some of these below.

Original payment to a close family member

If the original beneficiary is a close family member of a UK resident settlor, the original payment may be attributed to the settlor, under the rules described above. Where this is the case, the onward gift rules will not apply.

Arrangements or an intention

The rules will only apply where, at the time of the original payment, "there are arrangements, or there is an intention" as to the onward payment to a UK resident. This is a welcome refinement to the original provisions released last year, in that the rules will only be engaged where an onward payment is the intended outcome at the time of the original payment. Under the previous draft, the rules applied automatically where an onward payment was made within three years of the original payment, regardless of whether the two were connected. Clearly, this could have led to some bizarre results. In some circumstances, it would have been difficult both for taxpayers to know that they had a tax liability to report and for HMRC to police cases where the rules had been engaged inadvertently.

Nevertheless, the fact that the new rules turn on intention means that there continues to be plenty of scope for problems in practice. For instance:

- Demonstrating the existence, or absence, of an "arrangement" or "intention" will in some cases be very difficult.

- The legislation does not specify who needs to be party to the arrangement, or have the intention. On a plain reading, the mere existence of an intention (by anyone concerned) is sufficient. This raises a number of questions, including, for example, the extent to which a trustee or a subsequent recipient must have knowledge that an intention exists, or that arrangements have been made. In some cases, this could make compliance by subsequent recipients very difficult.

We expect HMRC to publish guidance on how they intend to interpret the provisions in practice. In the meantime, the legislation must be taken at face value, and prudence is advisable.

Timing

There are two points worth highlighting in relation to the timing of the original payment and the onward payment:

- If there is an intention or arrangement at the time of the original payment, the length of time between the original payment and the onward payment is immaterial.

- The rules can apply even if the onward payment was made before the original payment. In that event, however, the rules will only apply if it is reasonable to assume that the onward payment was made in anticipation of the original payment (for example, where a non-resident beneficiary, in anticipation of receiving a trust distribution, makes a payment to a UK resident).

Link between assets

The general rule is that there needs to be a connection between the assets received under the original payment and the onward payment – these provisions are very wide and they can apply where different assets are used to make the onward payment.

Limitations on the subsequent recipient's liability

The subsequent recipient will not be liable for tax to the extent that the original payment has already been subject to tax in the hands of the original beneficiary.

Subsequent recipient is a close family member

If a subsequent recipient is a close family member of a UK resident settlor, the onward payment may be attributed to the settlor (instead of the subsequent recipient). The position here mirrors the rules applying to distributions made to close family members directly:

- For income tax purposes, the onward payment will be attributed to the settlor where the subsequent recipient is either non-resident, or a remittance basis user and the onward payment is not received in (or remitted to) the UK.

- For capital gains purposes, the attribution to the settlor will occur regardless of whether the subsequent recipient is UK resident or a remittance basis user.

Series of gifts

The rules can apply where there is a series of transactions that culminates with a payment being received by a UK resident: for example, if the original beneficiary (being non-resident) makes a gift to another non-resident, who then makes a payment to a UK resident.

Payments made before 6 April 2018

All onward payments made after 5 April 2018 will be subject to the new rules, even if the original payment took place before that date.

This will not be the case where both the original payment and the onward payment took place before 6 April 2018. However, this does not necessarily mean that pre-6 April 2018 transactions along the lines of those targeted by the new provisions will not give rise to a tax liability: existing anti-avoidance rules may, depending on the circumstances, still cause this type of arrangement to trigger a tax charge.

Please get in touch with your usual contact for advice on how these provisions may affect you.

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