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CHANGES TO CGT TREATMENT OF OFFSHORE TRUSTS

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1. The draft FB 2017 clauses introduce a number of significant changes to the taxation of offshore trusts. Those changes are not limited to dealing with the consequences of the new deemed domicile rules.

OVERVIEW OF EXISTING RULES

2. Prior to considering the changes to existing rules on taxation of offshore trusts, it is useful to consider what those rules are.

3. Gains accruing to trustees of a settlement who are not resident in the UK ("an offshore trust") are generally not within the charge to capital gains tax. UK legislation applies to tax such gains in two principal ways:

   a) The settlor charge under section 86 TCGA 1992.

   b) The charge on beneficiaries receiving capital payments under section 87 TCGA 1992.

The settlor charge (section 86 TCGA 1992)

4. The settlor charge applies where a settlor of an offshore trust is both resident and domiciled in the UK in a tax year and has an interest in the settlement. For these purposes a settlor will have an interest in the settlement if property may become payable for the benefit of wide class of persons including spouses, children and grandchildren of the settlor (para 2, Sch. 5 TCGA 1992).

5. The charge operates by attributing to the settlor an amount of chargeable gains equal to what would be the chargeable gains of the trustees (including section 13 TCGA 1992 gains) if they were UK resident.

6. The charge is an unlawful restriction on the right to free movement of capital guaranteed under Article 63 TFEU. By treating offshore trusts less favourably than onshore trusts the UK restricts free movement of capital. There is no recognised

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justification for this treatment[1].

The beneficiary charge (section 87 TCGA 1992)

7. The beneficiary charge applies where there are untaxed gains within an offshore trust ("trust gains"), and the beneficiary receives a capital payment. The trust gains are treated as accruing to the beneficiary up to the amount of the capital payment. This applies whether the gains accrue in an earlier or later year to the capital payment.

8. At present, capital payments made to non-resident beneficiaries result in trust gains being treated as accruing to them. As the beneficiary is non-resident there is no charge to tax.

9. Where the remittance basis applies to a beneficiary, the capital payment is treated as deriving from the chargeable gains and a remittance basis applies (section 87B TCGA 1992).

10. This charge also represents an unlawful restriction on free movement of capital contrary to Article 63 TFEU. Even if it could be said that taxing at a beneficiary level the economic gain that beneficiary enjoys was a justification for the charge, the provisions do not do that.

THE PROPOSED CHANGES

11. Changes have been proposed to the existing regime. This follows from the introduction of a deemed domicile rule, but is not so limited.

12. The changes are contained in Part 2 to Schedule 12 of the draft clauses. That part is entitled "Protection of Overseas Trusts". That title is misleading.

13. There are broadly eight areas where the legislation effects changes:

    a) The non-application of section 86 TCGA 1992 to certain persons with a deemed UK domicile.

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[1] For a more in depth analysis of the EU law issues see *Capital Gains Tax and Offshore Trusts: Are sections 86 and 87 TCGA 1992 compliant with EU law?* (2013) Tax Planning Review Vol 2.1 (Rory Mullan) and for a general discussion of the issues see *The Interaction of EU Treaty Freedoms and the UK Tax Code*, Rory Mullan and Harriet Brown, Key Haven 2011

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b) The new settlor charge on certain capital payments to close members of the settlor's family

c) The new charge on capital payments to temporary non-residents.

d) Treatment of capital payments to a non-resident beneficiary on termination of a settlement.

e) Disregard of capital payments made to non-resident beneficiaries in all other circumstances.

f) Disregard of capital payments made to a migrating beneficiary.

g) Extension of the section 87 TCGA 1992 charge to settlements made by way of onward gift.

The non-application of section 86 TCGA 1992 to certain persons with a deemed UK domicile (para 5A Sch.5 TCGA 1992)

14. Section 86 TCGA 1992 applies where a person who is a settlor in relation to the settlement is domiciled in the UK at some time in the tax year (section 86(1)(c) TCGA 1992). The introduction of a deemed domicile rule potentially expands the scope of this section to persons with a deemed domicile.

15. An amendment to Schedule 5 TCGA 1992 limits the impact of this change. A new paragraph 5A has effect that section 86 TCGA 1992 will not apply to certain (but not all) persons who are not UK domiciled but are deemed to be ("deemed UK domiciliaries").

16. Notably, the discriminatory treatment of those deemed to be domiciled in the UK by reason of birth here is carried through to section 86 TCGA 1992[2]. Such a deemed UK domiciliary will be within the scope of the section 86 TCGA 1992 charge.

17. In order for a deemed UK domiciliary settlor to escape the section 86 TCGA 1992 charge for a tax year the following must be satisfied:

a) The settlor was neither domiciled in the UK nor (after 6 April 2017) deemed to

[2] Discrimination is prohibited not only under EU law. Discrimination in taxing matters on grounds of status is also contrary to Article 14 of the ECHR in conjunction with Article 1 to Protocol 1

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be domiciled in the UK at the time the settlement was created.

b) The settlor is neither domiciled in the UK, nor be deemed to be UK domiciled by reason of UK birth, at any time in the tax year.

c) At no time after 6 April 2017 when the settlor was deemed to be UK domiciled has any property been added to the settlement by either (i) the settlor or (ii) the trustees of another settlement of which the settlor is a beneficiary.

18. A settlement will not be tainted by a later addition if it is

a) Provided under an arms length transaction *or*

b) Paid in pursuance of a liability incurred before 6 April 2017 *or*

c) It is a payment to cover the difference between (i) taxation and administration expenses and (ii) settlement income.

19. A major planning issue will be in ensuring the settlement does not become tainted by a later addition. In that respect, making arrangements pre-April 2017 to cover future potentialities where the settlor might be expected to contribute will be an important consideration.

<u>The new settlor charge on certain capital payments to close members of the settlor's family (section 87G TCGA 1992)</u>

20. A new section 87G TCGA 1992 imposes a charge on a settlor where:

a) Section 87 gains are treated as accruing to a beneficiary in a tax year;

b) The beneficiary is a close member of the settlor's family (a spouse/civil partner or unmarried equivalent or a minor child: section 87H TCGA 1992);

c) The settlor is UK resident; and

d) The beneficiary is non-resident or the remittance basis applies and none of the section 87 gains is remitted.

21. The settlor is chargeable on the gains "as if they were chargeable gains accruing to the settlor". This should preserve the settlor's right to claim the remittance basis where the settlor is non-UK domiciled.

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22. There is a right to claim the tax from the beneficiary or the trustees. An interesting question is whether a claim from the trustees (extinguishing the claim against the beneficiary) is itself a capital payment. If not, there will be a tax, as well as a practical, benefit to claiming the indemnity from the trustees.

23. Given that a settlor will have an interest in any settlement in which his close family can benefit, the charge will only affect settlors who have been outside the scope of section 86 TCGA 1992 by reason of non residence for a period, or more likely non-UK domicile.

24. As currently drafted, the charge on a deemed domiciled settlor with a foreign domiciled spouse (or minor child) in receipt of a capital payment is manageable. Remittance of any section 87 TCGA 1992 gains by the beneficiary would exclude the settlor charge.

25. The position where a non-resident beneficiary is in receipt of a capital payment is more problematic. There is no possibility of remittance to prevent the charge arising.

26. The circumstances where a UK resident settlor has non-resident close family may not be especially common but is by no means impossible: a divorced UK resident and domiciled settlor may have minor children resident overseas who are provided for through a settlement.

27. Consideration might be given to limiting the scope of capital payments until the beneficiary reaches majority (e.g. by making loans rather than outright payments). There are issues to consider with how this might be structured. The consequences of a loan to a minor lacking legal capacity need consideration. Something less straight forward may be required.

28. The change applies to gains which are treated as accruing as a result of capital payments made in or after 2017/18. It therefore imposes a charge by reference to gains which have accrued before that date but which have not been matched with a capital payment.

29. It may be sensible to make capital payments before 6 April 2017 where this charge is potentially problematic.

<u>The new charge on capital payments to temporary non-residents (section 87E TCGA 1992)</u>

30. A capital payment made to a beneficiary in a period of temporary non-residence is treated as received by the beneficiary in the beneficiary's period of return. This replicates the current position, but is necessary to deal with the consequence of payments to non-residents being disregarded.

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31. Temporary non-residence has its para 110 Sch 45 FA 2013 meaning (in short): 5 years or less non-residence after a period of 7 years, 4 of which where years in which the person was UK resident and not treaty non-resident.

32. The period of return (para 115 Sch 45 FA 2013) is the first period of UK residence after departure for which the person is UK resident and not Treaty non-resident.

33. When applied in 2017/18 and later, this applies to payments received before 2017/18.

Treatment of capital payments to a non-resident beneficiary on termination of a settlement (section 87F TCGA 1992)

34. Where a settlement ceases to exist in a tax year, specific provision is made for capital payments made in that tax year. Those capital payments to beneficiary who has not been UK resident at any time in that tax year are recognised.

35. This applies to payments received in 2017/18 or later.

Disregard of capital payments made to non-resident beneficiaries in all other circumstances (section 87D TCGA 1992)

36. The above are all exceptions to the new general rule that in allocating trust gains to capital payments made after 6 April 2017 all previous payments to non-UK resident beneficiaries are to be disregarded.

37. This has the potential for considerable unfairness: it means UK resident beneficiaries will face tax charges on capital gains enjoyed by non-UK beneficiaries. It is not clear on what basis the UK lays claim to the right to tax such gains: that is gains which are realised outside of the UK to persons resident outside of the UK which are also ultimately enjoyed by persons resident outside the UK.

38. Transfers to different settlements and/or sub-fund elections to manage potential unfairness between resident and non-UK resident beneficiaries will be appropriate.

39. The provision has retrospective effect. In applying it to payments made after 2017/18 it applies to payments received before that date. This appears to have the consequence that payments to non-resident beneficiaries which were previously capital payments, are now to be disregarded.

40. That means that gains which have been washed will come back into a settlement. It may

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also mean that work has to be done working out how those gains are allocated on the basis that non-resident payments are disregarded.

41. In some case, it may be easier to simply bring a settlement to an end to prevent previously washed trust gains from coming back into charge.

42. In other case, it will be sensible to make capital payment to UK resident beneficiaries before 6 April 2017 where gains would not be attributed to that payment under current rules. Gains which come back into charge must then be set against that capital payment, in calculating trust gains for 2017/18.

Disregard of capital payments made to a migrating beneficiary (section 87J TCGA 1992)

43. A capital payment made in or before a particular tax year is disregarded if (i) the beneficiary is non-UK resident in that tax year and (ii) was UK resident in the tax year in which the payment was received.

44. This applies only to the extent that it has not been matched with trust gains for a year before 2017/18 or a year after 2017/18 in which the beneficiary is UK resident.

45. This is needed because the payment would not be disregarded as having been made to a non-resident, but would be matched with later trust gains at a time the beneficiary is non resident (and so outside the charge to tax).

46. The provision applies to matching of gains in 2017/18 and later, but does not have the same retrospective effect of section 87D TCGA 1992. This may allow scope for some planning pre-April 2017.

Extension of the section 87 TCGA 1992 charge to settlements made by way of onward gift (section 87I TCGA 1992)

47. The section 87 TCGA 1992 charge now extends to "onward gifts".

48. For this provision to apply there must be a capital payment received by a non-resident or remittance basis taxpayer which is not caught by the close family settlor charge.

49. A gift (or other conferral of a benefit) from that beneficiary to a UK resident "in anticipation" of the capital payment or within 3 years of it, is itself treated as a capital payment from the original settlement.

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50. An important question concerns how it is to be construed in practice. On one reading any gift or conferral of benefit is caught even if entirely unrelated to the original capital payment. For example, the annual Christmas presents of a non-resident beneficiary. It seems difficult to imagine that this is what was intended. The wording of the new provision leaves considerable uncertainty on the point. It is suggested that the treatment of an onward gift must sensibly be subject of a remoteness test.

51. That deemed capital payment can itself give rise to a further deemed capital payment.

52. The three year time limit is disregarded where there are arrangements in place for the capital payment to be received by a beneficiary who is not the original recipient of a payment.

53. The provision applies to onward payments made after 6 April 2017, regardless of when the original payment was made. Practically, this means that capital payments made after 6 April 2014 will potentially be caught, unless arrangements were in place in which case no time limit applies.

EU LAW

54. Despite voting to leave the EU, the UK has not done so. The extent of its obligations once it does so remain at present unknown. In any event, citizens are entitled to be taxed by reference to the law as it stands and not as it may be in the future.

55. The amendments breach the UK's obligations under EY law. They expand the application of provisions which were already in breach of the right to free movement of capital. They make those provisions all the more disproportionate in their application.

56. This is because even if it could be argued that the idea of section 87 TCGA 1992 is to ensure that gains within a settlement are taxed on UK residents when received by them (which is arguably a legitimate aim) they fundamentally do not achieve that. On the contrary, the UK now taxes offshore gains enjoyed by non-residents. That is an overreach at odds with international law.

57. The provisions also breach fundamental EU principles of legal certainty and legitimate expectations in their retrospective effect (see C-376/02 *Stichting 'Goed Wonen'*) (and raise serious questions in relation to the ECHR in that regard: *MA v Finland* (2003) 37 EHRR CD 210). Gains which had been washed by payments to non-residents years ago are now brought back into charge. Worse than that, there is no provision to relieve the penal consequences of section 91 TCGA 1992.

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58. That said, it is open to question whether the EU Commission will take any steps to require the UK to comply with its obligations. That will be left to individual taxpayers before the UK Courts.

CAPITAL GAINS TAX REBASING FOR PERSONS BECOMING DEEMED UK DOMICILED ON 5 APRIL 2017

59. Capital gains tax rebasing of assets to their market value on 5 April 2017 is available for assets held by certain individuals on that date.

60. The asset must not have been situated in the UK at any time between 16 March 2017 and 5 April 2017 (unless it is exempt property under section 809X ITA 2007).

61. To qualify, a person:

    a) must not be UK domiciled at any time from the 6 April 2017 until the date of disposal;

    b) must not be deemed UK domiciled by reason of birth in the UK but be deemed UK domiciled by reason of residence at all times from 2017/18 until the date of disposal; and

    c) must have claimed and paid the remittance basis charge before 2017/18.

62. The individual can elect for the rebasing not to apply.

63. If there is a risk of acquiring a UK domicile at a later date, it may be sensible to trigger a disposal, taking advantage of the relief while it is available.

64. Disposals of qualifying assets should be delayed until 5 April 2017.

CLEANSING OF MIXED FUNDS

65. Where there is a mixed fund section 809R(4) ITA 2004 treats any transfer from it as including an appropriate portion of income and capital.

66. The draft legislation includes provision for a one off election for that subsection not to apply to a transfer from a given fund.

67. To qualify, the person who's income or gains is the fund must have been a remittance basis taxpayer for any year before 2017/18. He must not be born in the UK with a UK

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domicile of origin.

68. The election only applies to a transfer of *money* from one account to another in the tax years 2017/18 to 2018/19. Only one election can be made per account.

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12 January 2017