UK AS A TAX HAVEN FOR INDIVIDUALS DOMICILED ABROAD

Ralph Ray[1]

The present IHT system is very favourable for non-UK domiciled individuals who may well be UK resident especially those with a domicile of origin being the form of domicile which is of a very clinging/tenacious character.

For a settlor domiciled outside the United Kingdom when a settlement is made, provided the assets are also outside the United Kingdom, the settlement will be and will remain excluded property for inheritance tax purposes, the domicile of the beneficiaries being irrelevant.

Accordingly, any non-United Kingdom domiciled settlor who is envisaging acquiring or reacquiring a United Kingdom domicile should urgently grasp the nettle and set up the appropriate settlement (probably a discretionary trust) before he becomes domiciled in this country. Moreover, the Capital Taxes Office currently accepts that the property remains excluded property under section 48(3), Inheritance Tax Act 1984 - i.e. not liable to inheritance tax - notwithstanding that the settlor has reserved a benefit in the asset gifted, for example by being included as a beneficiary. There are rumours, however, that this is being reviewed! Meanwhile see Revenue's Manual, Chap D para D8, example 2. The rumours are to the effect that this may be withdrawn for the future so that if the client settlor is a discretionary beneficiary, once he becomes UK domiciled e.g. because he has been resident in the UK for 17 out of the last 20 years, a gift with reservation situation will arise. This possible change of established practice is unlikely to be retrospective. However clients must be warned of the danger. This aspect is well covered in James Kessler's book "Taxation and Foreign Domiciliaries" published by Key Haven Publications PLC para 17.10.

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[1] Ralph Ray FTII TEP, BSc (Econ) Solicitor consultant with Wilsons of Salisbury.

Under section 267 IHTA 1984, an individual is deemed to be United Kingdom domiciled for inheritance tax if he or she has been resident in the United Kingdom for 17 out of the last 20 years of assessment. Accordingly such an individual should establish such a discretionary trust prior to the commencement of this 17 year period. (Because income tax years of assessment are relevant the period of residence can be as little as 15 years in certain circumstances). The fact that the settlor becomes United Kingdom domiciled subsequent to the creation of the trust is immaterial for inheritance tax as to that trust fund and as the law and practice stands. (But see above reference to possible changes of law and, or practice).

This valuable estate planning proposal for non domiciliaries is, however, subject to five main traps which must be carefully guarded against.

The first arises in the case of a settlement made by a non-United Kingdom domiciled settlor, where there is an initial interest in possession in favour of the settlor or his spouse, followed by discretionary trusts. Under section 80 Inheritance Tax Act 1984, the settlement is treated for the purposes of the discretionary trust regime as having been made by the person with the interest in possession at the time of its *termination*. Under section 82 the position is that the settlor or spouse at the date of the original settlement and that person with the interest in possession at the time of the termination of that interest have to be domiciled outside the United Kingdom (i.e. on *both* occasions), to ensure that the property is treated as excluded. The moral is do not mix the trusts, namely have one continuing trust, not an original form of interest in possession trust which is subsequently varied with a different species.

The second trap is to mix different categories of funds in one settlement. One should not have any United Kingdom assets in the discretionary trust of the non-United Kingdom situs assets because these overseas assets will then be taken into account in computing the rate, on a cumulation basis, of the United Kingdom property - even though, standing alone, such United Kingdom property would be within the nil rate band.

Thirdly it is important that no United Kingdom domicililed individual should provide any property to the trust as this could lose the section 48 excluded character of the trust. Although the Inland Revenue Tax Bulletin Feb 1997 p.398 has confirmed that the UK individual, as above, has probably created a separate settlement - this is subject to the vague qualification 'if the circumstances so require'.

Fourthly the excluded property character of the trust overrides the gift with reservation rules as the law and practice stands - but see above. Therefore there is no objection, at present, in the settlor being an object of the discretionary trust. The

settlor/beneficiary should not, however, be excluded subsequently by the trustees from benefiting in his or her lifetime as that will then constitute a deemed potentially exempt transfer Finance Act 1986 section 102(4).

Fifthly, the creation of this settlement could have income tax disadvantage as a 'transfer of assets' under TA 1988 ss.739-740 as tightened up by FA 1997 s.81, notwithstanding non-UK resident at the time of the transfer of assets.

Possible Form of New Re-Elected Labour Government Legislation

The re-elected Labour Government may adopt the Law Commission report and draft Domicile Bill to the effect that foreigners resident here will be assessed to CGT and income tax on a residency basis and the IHT exemption may also cease to apply. This would be the end of the concept of domicile of origin as we know it, however, Governments are aware that this change of law could cause a run on sterling - something about the Baltic exchange.