

## The Offshore Taxation Review

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# IHT: UK AS A TAX HAVEN FOR INDIVIDUALS DOMICILED ABROAD.

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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 and perhaps also pre-the General Election. Moreover, the Capital Taxes Office accepts that the property remains excluded property under section 48(3), Inheritance Tax Act 1984 ("IHTA") - 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.

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Under section 267 IHTA , an individual is deemed to be United Kingdom domiciled for inheritance tax purposes 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.

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 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 preferable that no United Kingdom domiciled individual should provide any property to the trust as this could lose the section 48 IHTA excluded character of the trust. Although Inland Revenue Tax Bulletin February 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. Therefore, there is no objection 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 disadvantages as a 'transfer of assets' under TA 1988 ss739-740 as tightened up by FA 1997 section 81, notwithstanding non UK resident at the time of the transfer of assets.

#### **Likely form of Labour Government Legislation**

- The Labour Government adopts (e.g. FA 1999) 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.

#### **Suggested Action Now: IHT**

An individual who is currently non UK domiciled should place the bulk of his assets in a non UK resident discretionary trust where such an individual could be included as a discretionary beneficiary without breaching the IHT gift with reservation provisions.