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Section 35 and Schedule 10: settlements: anti-avoidance etc

1. Background to the changes

Schedule 10 to the Finance Act 2018 (FA 2018) represents the final stage of the complex changes to the taxation of non-domiciliaries (non-doms) first announced in July 2015[1] and largely enacted in the Finance (No.2) Act 2017 (F(No.2)A 2017).[2]

The central plank of these changes was the introduction of a concept of deemed domicile for *all* UK tax purposes for any foreign domiciliary (foreign dom) who has lived in the UK for 15 years in a 20 year period as well as denying the benefits of non-domiciled status to any UK resident who was born in the UK with a UK domicile of origin but acquired a foreign domicile of choice.[3]

However, the Government decided that an incentive was needed to encourage foreign doms to stay in the UK after becoming deemed domiciled. Hence overseas assets held in a non-resident

[1] See HMRC, Guidance, *Technical briefing on foreign domiciled persons changes announced at Summer Budget 2015* (8 July 2015), available at: *https://www.gov.uk/government/publications/technical-briefing-on-foreign-domiciled-persons-changes-announced-at-summer-budget-2015* [Accessed 6 August 2018].
[2] F(No.2)A 2017 s.29 and Sch.8, s.30, s.31 and Sch.9.
[3] Commonly called a formerly domiciled resident or FDR. For more detail on these changes see R. Vos, "Section 29 and Schedule 8: deemed domicile: income tax and capital gains tax; Section 30: deemed domicile: inheritance tax; Section 31 and Schedule 9: settlements and transfer of assets abroad: value of benefits" [2017] BTR 572.

trust set up before the settlor became deemed domiciled remain largely outside the scope of UK tax until the foreign dom receives benefits or distributions from the trust. Such trusts are called "protected trusts" and must be set up prior to the foreign dom becoming deemed domiciled. Property cannot be added to protected trusts after the foreign dom has become deemed domiciled otherwise the trust loses its protections and the foreign dom is generally taxable on all the trust gains and income.

The principal benefit of a protected trust is that all foreign source income and most gains within the structure can continue to be rolled up tax free. However, the settlor must not be domiciled as a matter of common law in the UK, even if they are deemed domiciled and UK resident for tax purposes. Trusts set up before the settlor becomes deemed domiciled can also continue to qualify for inheritance tax (IHT) protection.[4]

In short, Government policy was to allow such trusts to continue as a tax efficient roll up vehicle provided the wealth remained within the trust. However, once the UK resident foreign dom received any benefits or distributions from the trust, the Government wanted to ensure that UK tax was paid. The law was therefore changed in a number of ways to achieve this. The result has been a legislative jigsaw of astonishing complexity containing traps and loopholes. This complexity has been increased by the fact that some changes were enacted in F(No.2)A 2017 and others in FA 2018. It is perhaps a classic case of how a relatively simple policy—*namely*, foreign doms should be taxed on benefits they receive from trusts—has metamorphosed into an anti-avoidance code that few can understand and on the detail of which tax professionals themselves disagree. Despite various problems and glaring loopholes being pointed out to HMRC during the consultation process by representative bodies such as the Society of Trust and Estate Practitioners and the Chartered Institute of Taxation almost no changes were made to Schedule 10 FA 2018 after it was published in draft.[5] Further questions have been asked by the representative bodies about the meaning of Schedule 10 FA 2018. It remains to be seen what answers are given.

There are five main changes to ensure that benefits and distributions from trusts are properly taxed. The first two changes (set out below) were enacted in F(No.2)A 2017 with effect from 6 April 2017 and aimed to ensure that benefits received by foreign doms were taxed at their proper value. These were discussed by Vos in his note "Section 29 and Schedule 8: deemed domicile: income tax and capital gains tax; Section 30: deemed domicile: inheritance tax; Section 31 and Schedule 9: settlements and transfer of assets abroad: value of benefits" published in this *Review* in 2017.[6]

1. The first change provided that all foreign doms would pay tax on an arising basis from their 16th year of UK residence on any personal income or gains and on any

[4] Provided the settlor is not an FDR

[5] STEP, *STEP comments on the deferred anti-avoidance provisions for offshore trusts published for consultation on 13 September 2017* (for inclusion in Finance Bill 2017-20 (25 October 2017), available at: *https://www.step.org/sites/default/files/STEP%20comments%20on%20the%20deferred%20anti-avoidance%20provisions%20for%20offshore%20trusts%20.pdf* [Accessed 28 August 2018]; *Written evidence submitted by the Chartered Institute of Taxation (Clause 35 and Schedule 10) further submission (FB23)* (11 January 2018), available at: *https://publications.parliament.uk/pa/cm201719/cmpublic/financeno2/memo/fb23.pdf* [Accessed 28 August 2018].

[6] Vos, above fn.3, 576 and 573 respectively.

benefits received from trusts, irrespective of where the benefit was enjoyed or the capital paid.

2. The second change was enacted in Schedule 9 F(No.2)A 2017 and introduced a statutory regime to value benefits received by UK resident beneficiaries from trusts (whether the beneficiaries were settlors or not and wherever domiciled). This was to ensure that where, for example, beneficiaries received loans from trusts or used houses or art owned within a trust structure, they paid tax on the true economic value of the benefit. Until April 2017 beneficiaries and HMRC were often engaged in long arguments over the correct value of the taxable benefit. Thus a beneficiary borrowing from a trust with interest rolled up and compounded might argue that the loan was commercial and there was no taxable benefit even though no interest was actually paid. From 6 April 2017, if no interest is actually paid on a loan, the taxable benefit is deemed to be 2.5 per cent (that is, the official rate of interest) of the capital value of the loan.[7] Similar rules were introduced for chattels to deem the taxable benefit to be the official rate of interest multiplied by the acquisition cost of the item.

Schedule 10 FA 2018 introduced three further changes effective from 6 April 2018.[8] These changes affect all beneficiaries of non-resident trusts not just settlors and not only those who are deemed domiciled. Broadly Schedule 10 FA 2018 aims to achieve the following objectives:

3. Capital gains arising within offshore trusts can no longer be "washed out" by capital payments to non-residents.[9]
4. What is now commonly known as the "recycling" or "anti-conduit" rule prevents payments being made from trusts to non-residents or foreign doms who are on the remittance basis and then being "recycled" by onward gifts to UK residents. In these circumstances the UK resident can pay capital gains tax (CGT) as if they had received it directly from the trust.[10] A similar onward gifts rule is introduced for income tax purposes from 6 April 2018 to prevent the benefits charge under the settlements code and the transfer of assets abroad rules from being circumvented.[11] In this note the writer focuses on the CGT provisions.
5. Under "the close family member rules", a UK settlor who is resident (whether or not deemed domiciled here) is potentially taxed on trust income or gains if a distribution is made to a close family member (cohabitee, minor child, spouse, civil partner). It does not matter where the close family member is resident. Nor is it necessary for the settlor to receive the distribution from the close family

[7] TCGA s.97A. Although note there are differences in the way the income tax and CGT rules operate in the taxation of loans. For transfer of assets purposes there still has to be a taxable benefit before the statutory provision operates. In the case of the CGT legislation this is not so and the loan may be commercial but the beneficiary will still be subject to the statutory regime in F(No.2)A 2017 Sch.9.

[8] In addition, FA 2018 Sch.10 extends the settlements code to tax benefits received by settlors and close family members from 6 April 2018. Benefits are matched with untaxed protected foreign source income (PFSI) in the trust. (FA 2018 Sch.10 inserting ITTOIA ss.643A–H.) These changes are not discussed in this note.

[9] See new TCGA s.87D.

[10] See new TCGA ss.87I–M.

[11] FA 2018 Sch.10 inserting ITTOIA ss.643IN and ITA 2007 ss.733B–E.

member. It is simply enough that a distribution is made from a non-resident trust to a close family member at a time when the settlor is UK resident.[12] Hence if a minor child or a spouse resident or domiciled abroad ("the original recipient"[13]) receives a capital payment from the trust, if the settlor is UK resident in any part of the tax year they are deemed to have received the payment direct from the trust and trust income and gains are attributed to them accordingly. If the settlor is not yet deemed domiciled and the capital payment is made abroad to the original recipient and not remitted the settlor can claim the remittance basis. Trustees will therefore need to inform a UK resident settlor when a payment is made to a close family member, its amount, the identity of the recipient and the amount of the trust gains. The settlor must pay any tax due and can recover the amount of the tax from the original recipient.

This note focuses on the two remaining rules in Schedule 10 FA 2018, namely the "onward gift rule"[14] and the "disregard of capital payments to non-residents" rule.[15]

2. Onward gift rule

New section 87I of the Taxation of Chargeable Gains Act 1992 (TCGA) inserted by paragraph 1 of Schedule 10 FA 2018 sets out the basic conditions for the recycling rule to apply for CGT purposes:

1. A capital payment ("the original payment") is received in a tax year ("the payment year") by a person ("the original beneficiary" called "A" in this note) from the trustees of the settlement. Note the original beneficiary A does not have to be the settlor.
2. At the time of the receipt there are arrangements, or there is an intention as regards the direct or indirect passing on of the whole or part of the original payment. It is not clear whose intention is relevant here but it could be that of the original beneficiary or the trustees. The term "arrangements" is notoriously wide.[16]
3. It is reasonable to expect that in the event of the original payment being passed on to another person that other person will be UK resident when they receive it. Note that the other person (B) does not have to be a beneficiary of the trust or even know about it. Nor does it appear to matter that when B receives the payment they are non-UK resident but only "temporarily non-resident" and might return within five to six years of leaving. The test looks at the residence status in the year of the onward gift.

[12] See FA 2018 Sch.10 inserting TCGA ss.87G–H and ITTOIA s.643A(2)–(4).
[13] New s.87G(1)(c) TCGA.
[14] FA 2018 Sch.10 para.1 inserting new TCGA s.87I "Non-UK resident settlements: recipients of onward gifts".
[15] FA 2018 Sch.10 para.1 inserting new TCGA s.87D "Sections 87 and 87A: disregard of capital payments to non-residents".
[16] *Snell v HMRC* [2006] EWHC 3350 (Ch) at [28]; [2007] STC 1279.

4. A does make an onward gift to B (and "gift" is defined to include any benefit) which includes the whole or part of the original payment directly or indirectly.[17]
5. The gift is made within three years of the start time (generally the date the distribution was received by A from the trust) or in anticipation of such a distribution.
6. B is UK resident in the tax year when the gift is received.
AND
7. There is at least one year beginning with the payment year and ending with the gift year during which A is not UK resident or the remittance basis is applicable.

This apparently straightforward series of conditions raises issues of some complexity.

Example 1

Non-resident trust makes a capital payment to A; A is resident and domiciled in the UK and is not a close family member of the settlor (otherwise section 87G TCGA applies to tax the settlor). A makes an onward gift to B two years later. B is not taxable on the gift as A is resident and domiciled in the UK.

If, however, A was a remittance basis user and did not remit the funds, or A was non-resident, the intention of the legislation is to tax B (assume B is a UK resident UK domiciliary) as if he had received the payment direct from the trust.

If the gift from A to B is made within three years of the trust distribution to A it is presumed "unless the contrary is shown" that the recycling rule does apply.[18] However, if there was no arrangement and no intention at the time of the payment for A to make an onward gift, the presumption can be rebutted.

Example 2

A is a non-UK resident who receives a large distribution from the trust. He wants the money for his investment in property in Dubai. Shortly afterwards he dies unexpectedly and his estate passes to his children all of whom are resident in the UK. Here the recycling rule should not apply as the presumption can be rebutted.

Conversely, if A received the trust distribution with the express aim of giving it to his UK resident children but waited three years before doing so, the recycling rule would not apply. The three year rule seems absolute.

What happens if A gives the property to B who gives it to C, that is, there is a series of gifts? The legislation provides for this under section 87I(2) TCGA and the gift from B to C is treated as a gift from A to C. It appears that the three years run from the date A receives the distribution and not from the date B gives it to C although the legislation is not entirely clear.

[17] FA 2018 Sch.10 para.1 inserting new TCGA s.87I(1)(d).
[18] See TCGA s.87I(8).

Example 3

Non-resident trust (Trust 1) makes a capital payment to A. A gives it to B (say a non-UK resident trust) two years later. 18 months after that (so three and a half years after the original capital payment), the trust B makes an onward gift to C who is UK resident and domiciled. Assume all other conditions are met.

1. Section 87I(2)(b)(i) TCGA suggests that the rules on series of gifts are engaged because the A to B gift is made within three years of the making of the capital payment to A.
2. However, the effect of section 87I(2) TCGA is to treat the B to C gift as though it were an A to C gift and to read that back into section 87I(1)(c) TCGA. Is C taxed as if he had received a distribution from Trust 1?
3. Section 87I(1)(c) TCGA, however, only applies if the onward gift (now the deemed A to C gift) is made within three years.
4. However, the gift to C is made after three years and so the rule does not apply. This suggests that A can settle the funds he receives from Trust 1 into Trust 2 immediately. As long as Trust 2 waits three years from the distribution from Trust 1 to A, Trust 2 can then make a payment to B and the gains and income of Trust 1 are not attributed to B.

Having said that, this interpretation seems to make section 87I(2)(b)(i) TCGA redundant. However, the alternative is that the B to C gift is not only treated as made by A, but also deemed to be made at the same time as the A to B gift. In that event, if beneficiary A immediately resettled the distribution from Trust 1 into a new Trust 2 there would be no time limit on the onward gifting rules as a payment from Trust 2 to B would always be treated as being made in the year when A resettled. There seems to be no justification for this extra deeming.

Although the payment to the intermediary is ignored for some tax purposes, it is not ignored for all tax purposes. Assume A receives a cash distribution from a trust in year 1 and six months later A gives that cash to his wife who is UK domiciled but non-resident. One year later A's wife gives the cash to her daughter who is UK resident. That cash gift is caught by the recycling rule and the daughter is treated as receiving it from the trust for the purposes of the transfer of assets code/settlements code and the CGT code in sections 87 to 97 TCGA. A's wife dies within seven years of the gift. For IHT purposes her gift is not ignored and she is treated as having made a chargeable transfer.

It is therefore important that UK resident donees who receive gifts from non-resident individuals or foreign doms make reasonable enquiries to determine whether they are caught by this legislation. If it turns out that the gift to them from the non-resident is derived from a trust the donee will need to ascertain how much of the gains and income of the trust should be attributed to that capital payment and taxed accordingly.

The scope of the recycling rule is potentially wider than might at first be thought.

Example 4

The trustees of a settlement, established for primarily IHT planning reasons, de-envelope a valuable UK residential property and bring the settlement to an end by appointing the assets to the non-UK resident and domiciled settlor. There is no income in the structure.

The settlement is brought to an end because the initial advice to envelope and settle is no longer considered appropriate, as a result of Schedule A1 to the Inheritance Tax Act 1984. The family all use the flat as a London pied-à-terre rent free. This includes both the settlor, his wife and a UK resident adult daughter. Since "gift" includes benefit, the rent free use of the property by the daughter would appear to be caught by the recycling rule.

Example 5

Assume A is non-resident and receives a capital distribution from a trust. He lends the funds to his sister in the UK to help her buy a UK property charging her zero interest. In these circumstances not only is his loan a relevant loan and chargeable for IHT purposes but as the loan to his sister is interest free she is treated as receiving a taxable benefit from the trust equal to the official rate of interest (now 2.5 per cent) of the capital value of the loan.

Although wide, the legislation also has some worrying loopholes. The most obvious gaps are in relation to distributions where A is UK resident but a remittance basis user or B (the onward recipient) is a remittance basis user.

To understand this part of the legislation it is necessary to consider how the normal matching rules work. Where the original trust distribution is made to A who is UK resident but a remittance basis user, it is matched to trust gains. If he brings all the distribution to the UK he will be taxed in the normal way on the remittance basis. In that case there is no need to tax any onward recipient as A has already paid tax on the matched trust distribution. However, what happens if the payment of say £100 to the original beneficiary A is only partially remitted by A and some of it (say £60) is retained and given to B abroad within three years, who then remits the £60? (Assume B is not a relevant person in relation to A, that is, not a minor child, spouse, cohabitee, etc. and that A is not a close family member of B the settlor where the rules become more complicated.) There are also complications if A does not remit by the time he makes an onward gift to B. However, the general intent is that B should be taxed on that part of the capital payment that has not been subject to tax in the hands of A. However where Schedule 4C TCGA is engaged the effect of section 87J(5) TCGA is to switch off the onward gift rule because all the gains matched to A are treated "as taxed" under the legislation even if they are not remitted and are not actually taxed at all on A!

Example 6

Giles, who is a remittance basis user, receives a distribution of £100,000 from an offshore settlement. The distribution is matched against the trust's Schedule 4C TCGA gains pool.[19] Giles is not taxed on the distribution as he pays tax on the remittance basis and has not remitted any part of the distribution to the UK.

[19] TCGA Sch.4C.

The reason Giles requested the distribution was because he wanted to make a gift of £100,000 to his adult son who is buying a house in the UK. The son is UK resident and deemed domiciled. The gift is made within three years of the distribution. For the purposes of section 87J TCGA, it appears that the whole of the original payment to Giles is the taxed part of a matched amount.[20] Even though Giles has not paid tax on the distribution, the onward gift rule does not apply as section 87K TCGA only has any effect if the original distribution is not a "matched amount" (that is, matched to the section 87 TCGA pool) or if there is an untaxed part of the "matched amount".

Further gremlins emerge when looking at sections 87K and 87M TCGA where the subsequent recipient B is a remittance basis user. Assume that the first payment is made to the original non-resident beneficiary A and is therefore not matched against gains. The subsequent recipient B is a UK resident remittance basis user and is treated under section 87K TCGA as having received a capital payment from the trust; on one interpretation the effect of section 87M(1) and (2) TCGA is that B is not taxable on that capital payment, even if it is remitted to the UK. If that is right then it means the anti-conduit rules have in practice no effect for CGT purposes where B is a remittance basis user.

The position is slightly different where the original payment is made to A who is a remittance basis user but does not remit the payment and it is therefore matched to section 2(2) TCGA trust gains (not Schedule 4C TCGA gains) but not taxed. Instead of the subsequent recipient B being treated as having received a capital payment, B is treated as if chargeable gains had accrued to him (as a result of the payment to the original beneficiary A being matched against gains but not having been taxed). In these circumstances the effect of section 87M(3) and (4) TCGA is, arguably, that B is taxable if the onward payment is remitted in the year of receipt but is not taxed if it is remitted to the UK in a subsequent year.

Whether or not a subsequent recipient who is a remittance basis user is taxable therefore seems to depend on whether B is treated as receiving a capital payment or whether B is treated as if chargeable gains have accrued to him. In the former case, B will not be taxable but will be capable of making a further gift which itself is within the scope of the onward gift rules. In the latter case, B is taxable to the extent that the onward payment is remitted in the year it is received but arguably not if it is remitted in a later year.

The equivalent income tax provisions in section 643I of the Income Tax (Trading and Other Income) Act 2005 to prevent recycling are similarly flawed. Indeed the reference to "available protected income" suggests that if there is no such income in the trust (because the settlor has been non-UK resident since April 2017) and trustees distribute trust income to a non-resident beneficiary *as an income not a capital distribution*[21] any subsequent onward gift of that income to a UK resident (who is not a relevant person or the settlor of a close family member) cannot be caught.

All the above loopholes may be ripe for challenge by HMRC under the General Anti-Abuse Rule (GAAR). The safest course is for the original recipient, A, to wait three years before considering any onward gifts to any UK resident.

[20] TCGA s.87J(5).
[21] Otherwise the provisions in TCGA s.87I are in point as a capital payment.

3. Disregarded payments to non-residents—sections 87D to 87F TCGA

Example 7

Prior to April 2018, if a trust had a fund worth, say, £1million and section 2(2) TCGA gains of £500,000, it could make a distribution of half the trust capital to non-resident beneficiary A in year 1 and then end the trust in year 2 in favour of UK resident beneficiary B. This enabled trustees to "wash out" the section 2(2) TCGA trust gains by payments to non-residents first. Beneficiary B could then receive the balance of capital tax free (assuming there was no relevant income in the trust structure).

However, it was not all good news as a non-resident beneficiary who received a capital payment when a non-UK resident could find themselves subsequently being taxed when resident in the UK if the capital payment was only matched to trust gains realised then. For example, it was common for trustees of large family trusts which had no connection to the UK to make a capital payment to enable say the daughter to buy a house in the UK when she first arrived in the UK to study. The capital payment would be made in the tax year prior to the daughter first becoming UK resident. If the payment was matched to trust gains in the year of the payment no further tax arose. However, if at the time of the capital payment there were insufficient gains in the trust to match to the capital payment in full then the daughter could be taxed at a later date when UK resident as and when trust gains were realised. From 6 April 2018, no account is generally to be taken of any capital payments to non-residents and therefore this problem largely ceases.[22]

Section 87D TCGA provides that capital payments made to non-residents are left out of account. There is no split year basis any more so if A is resident in the UK for even part of the year they are taxable on all the gain (subject to the remittance basis). Thus in the case of Example 7 a payment made to A in year 1 would not wash out any of the gains and the payment to B in year 2 would be fully chargeable to CGT. This is the case even if A paid tax in their country of residence on the same trust gains.

The rule can have more far reaching effects than first anticipated. For example, suppose B, a UK resident, received a capital payment many years ago, for example, rent free occupation of a property. The property is now to be sold and trust gains realised. The original plan had been to wash out the gains by making capital payments to A, a non-UK resident beneficiary, in the year the gain is realised. It cannot then be carried back and matched to the earlier benefits received by B. This will no longer be possible.

There are three exceptions to the rule that capital payments to non-residents are left out of account:

1. If A is a non-resident close family member and the settlor is UK resident. In these circumstances the settlor is immediately taxable on the gains that are attributed to A.
2. If A is temporarily non-resident.
3. If the trust is ended and two or more beneficiaries, one of whom is UK resident and one of whom is not, receive capital payments from the trustees. In that case

[22] There are exceptions if the beneficiary is only temporarily non-resident or the trust ends in the year of payment

> the gains are pro rated between the beneficiaries. Hence, in Example 7 if the trustees ended the trust and made the payment to A and B in the same tax year, B the UK resident would pay tax on only half the gains and the other half would be washed out.

It is still possible to wash out trust gains by making payments to UK residents who are remittance basis users (subject only to the close family member rule—if the recipient is a close family member of a UK resident settlor the settlor can still be taxable).

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Capital gains tax; Deemed domicile; Foreign domiciliaries; Income tax; Offshore trusts; Settlements; Tax avoidance