FOTRA securities: a question of residence for inheritance tax

Inheritance tax and trusts

FOTRA securities: a question of residence for inheritance tax
21 March 2023

For inheritance tax purposes, owners of FOTRA shares (Free of Tax to Residents Abroad) are required to be simply non-resident, not non-domiciled, to meet the conditions for exemption. This can result in some significant advantages.

Key Points

What is the issue?

Inheritance tax planning on the basis of attaining or retaining non-domiciled status can be difficult owing to the deemed domicile rules. Transfers of value involving FOTRA securities (Free of Tax to Residents Abroad) can be a powerful tool when it comes to planning.

What does it mean for me?

Inheritance Tax Act 1984 s 6(2) provides for excluded property status for FOTRA securities in circumstances which no longer require the owner to be non-domiciled, but simply non-resident.

What can I take away?

The purpose of this article is to highlight the virtues of inheritance tax planning with FOTRA securities, in terms of certainty, simplicity and the relative lack of transaction costs and volatility in value.

There are not very many tools in the inheritance tax planning toolbox. One of the most powerful of these tools is that of making transfers of value involving FOTRA – 'Free of Tax to Residents Abroad' – securities. FOTRA is defined in ITTOIA 2005 s 713, in part by reference to Finance (No. 2) Act 1931 s 22.

The current position is simple (apart from an exception for the 3½% War Loan) and is stated clearly by HMRC: 'All government securities acquired on or after 6 April 2013 will be exempt provided the beneficial owner is resident outside the UK' (IHTM 4291).

FOTRA securities have income tax advantages in certain circumstances, and disposals of gilts are also exempt from capital gains tax. However, the focus of this article is on their very considerable inheritance tax advantages, as FOTRA securities held by a non-resident are excluded property under Inheritance Tax Act (IHTA) 1984 s 6. This article discusses the UK inheritance tax issues and does not consider investment aspects, on which advice should be sought.

FOTRA securities held outright

When an individual transfers a beneficial interest in excluded property to another person, no account is taken of that property in quantifying the loss to the estate of the transferor (IHTA 1984 s 3(2)). A lifetime transfer by an individual, either outright to another individual or to the trustees of a settlement, is outside the scope of inheritance tax to the extent that it is comprised of excluded property. Excluded property is also deemed not to form part of the person's estate immediately prior to their death (IHTA 1984 s 5(1)(b)).

'Excluded property', as it applies to property in which an individual has a beneficial interest, is defined in IHTA 1984 s 6. Property is excluded under IHTA 1984 s 6(1) if it meets two conditions: the property is outside the UK; and it is owned by a non-UK domiciled individual. There are other definitions; for example, investment in open-ended investment companies in the UK is still excluded property, but the owner must be non-UK domiciled.

Section 6(2), however, provides for excluded property status for FOTRA securities in circumstances where the owners meet the conditions for exemption. These no longer require the owner to be non-domiciled, but simply non-resident.

FOTRA securities held in trust

FOTRA securities held in trust will be deemed to be excluded property if they meet the conditions in IHTA 1984 sub-s 48(4) relating to 'qualifying interest in possession'. Practitioners are most likely to encounter this in interest in possession trusts, to which an individual became entitled prior to 22 March 2006, and immediate post-death interest.

Where an individual has a qualifying IIP, it is their residence status that matters when considering whether gilts held on trust are excluded property. The residence status of the trust or the domicile of the settlor is irrelevant (sub-s 48(4)(a)).

Where no qualifying IIP subsists in the settled property (for example, where it is a discretionary trust), then excluded property status will be conferred on the trust assets (thereby avoiding relevant property status) if only non-UK resident persons could conceivably benefit from the settlement (sub-s 48(4)(b)). The conditions are stringent, and may not be acceptable in practice.

This type of trust may be appropriate where there is a realistic prospect of the intended beneficiaries themselves becoming non-resident at some point in the future, even they are not so resident at present. A decision to implement a trust meeting the conditions under sub-s 48(4)(b) would require careful thought.

In situations when the trust assets do not benefit from excluded property status because the beneficiaries include UK resident individuals, the use of FOTRA securities can still provide very substantial advantages by the absence of an immediate charge on the creation of such a settlement.

Planning with lifetime outright gifts

First, we consider making outright gifts to individuals. Normally, such gifts are potentially exempt transfers and will only escape the UK net if the donor survives seven years.

Example 1: Mr Brown moves abroad

Mr Brown, who is UK domiciled, becomes non-UK resident in 2021/22. In that year, he gifts £1 million in FOTRA securities to his son and daughter in equal shares. He returns to the UK and dies in 2023/24.

It is possible for an individual to become non-resident without necessarily becoming resident in any other country in a given tax year. It would be possible for Mr Brown to become non-UK resident by spending time in, say, France, Spain and Germany in 2021/22, without becoming resident for tax purposes in any of those countries. (He retains no home in the UK and ensures that he spends more time in one other country than the UK in that year.)

As far as UK inheritance tax is concerned, the gift will not be a potentially exempt transfer. Rather, as a gift of excluded property, it will not be taken into account for inheritance tax purposes. Mr Brown will need to consider the inheritance tax/gift position in any of the countries where he spends time.

No statutory holding period

Unlike with business property relief (BPR) or agricultural property relief (APR) assets, there is no holding period necessary for the exemption under FOTRA securities to apply and no clawback. However, in its Inheritance Tax Manual (IHTM4292), HMRC states: 'If a worthwhile amount of tax is at stake you should investigate the possibility of a last-minute purchase.'

It is unclear what grounds for challenge HMRC may have in mind in view of the absence of a statutory holding period. If gilts are acquired last minute, then gifted, and immediately sold, HMRC *may* mount a challenge to the effect that the gift is in reality a gift of cash and not FOTRA securities. This will depend on all the circumstances. A reasonable holding period between the acquisition by the donor and the gift, and between the acquisition by the donee and their sale, should cover off any such challenge.

Disclosure of tax avoidance schemes?

HMRC has declined to state categorically that arrangements involving gilts would never be caught by the disclosure of tax avoidance scheme (DOTAS) rules. Thought will need to be given on a case by case basis, but it is suggested that it is unlikely that planning involving gilts in any of the examples considered in this article would meet the conditions required for DOTAS to apply.

Planning with deemed lifetime gifts

The termination of a qualifying interest in possession in settled property, such that one or more individuals become absolutely entitled to it, is a potentially exempt transfer in normal circumstances. For example, where a widow is entitled to an immediate post-death interest in property settled in her late husband's will and terminates her interest in possessionin circumstances where her children become absolutely entitled to the property.

Such standard immediate post-death interest trusts could benefit from investment in FOTRA securities.

Example 2: Investment in FOTRA securities

Mrs White is a widow. She is entitled to an immediate post death interest in a trust fund of £1 million, settled in her late husband's will. The fund is comprised of FOTRA securities.

Mrs White becomes non-UK resident in the 2022/23 tax year. The trustees exercise their overriding powers of appointment to make an appointment of the trust to her two adult children. Termination of a qualifying interest in possession in circumstances when individuals become entitled is *deemed* to be a transfer of value by that individual under UK law. As the termination of Mrs White's interest in possession is a transfer of value of the FOTRA securities, it is a transfer of excluded property so there is no charge.

Mrs White will need to consider the inheritance tax/gift tax position in any of the countries where she spends time.

Planning with lifetime settled gifts

Where an individual makes a transfer of value to a settlement, whether a discretionary settlement or an IIP settlement, such transfers are immediately chargeable at 20% under Inheritance Tax Act 1984 s 7(2). This is, of course, a significant deterrent to the creation of settlements.

The transfer by a non-domiciled individual to trustees of a settlement of non-UK situs property is not chargeable, due to being a transfer of excluded property under s 6(1). However, the same result can be arrived at by an individual who is non-UK resident, and makes a transfer of FOTRA securities to trustees of a settlement.

Example 3: A discretionary family trust

Mr Grey, who is UK domiciled, ceases to be UK resident in that year in the tax year 2022/23. He transfers gilts worth £1 million into a discretionary family trust, with UK resident trustees. The beneficiaries include UK resident family members. Mr Grey returns to the UK in 2023/24. Under the terms of the settlement, he is wholly excluded from benefiting from the trust.

From a UK perspective, the transfer of the gilts into trust will be a transfer of excluded property and will therefore not be liable to the 20% charge. Mr Grey will need to consider the inheritance tax/gift tax position in any of the countries where he spends time.

Once settled, the trust fund is subject to the relevant property regime, with 6% ten-yearly charges. If the trust is UK resident, the trustees will be liable to income tax and capital gains tax on an arising basis, and none of the costs and complications attending offshore trusts will apply. Further, the Transfer of Assets Abroad provisions will not apply as assets will have been transferred to UK resident trustees by a non-resident individual.

Finally, if Mr Grey is wholly excluded from benefiting from the trust fund, he will not have reserved an interest in it for the purpose of the gifts with reservation of benefit (GROB) rules. If the GROB rules did apply, this would be problematic because the trust fund would not be excluded property in itself; and on his death Mr Grey would be deemed to own the trust assets for inheritance tax purposes.

Planning with the inheritance tax charge on death

It is never possible to predict the time at which an individual will die. Nor it is possible to predict whether the length of the time that they have spent abroad will mean that a foreign state will seek to impose inheritance tax on their assets.

If an individual is resident abroad in the year of death (or is likely to be), it is possible to plan for the eventuality that on their deaths, they will be subject to UK inheritance tax. Should that eventuality materialise, it would

clearly be beneficial for their liquid assets to be transferred into FOTRA securities, thus securing excluded property status.

Example 4: Overseas residence at time of death

Mrs Pink, a widow, moves to Italy from the UK in March 2022. She is diagnosed with a terminal illness in May 2022, and remains in Italy until her death on 4 July 2022.

Mrs Pink has liquid assets of £1 million. She decides to invest her assets in FOTRA securities, which remain in her estate until her death.

From a UK inheritance tax point of view, Mrs Pink will be deemed domiciled for UK inheritance tax. She may be factually domiciled in the UK on death, depending on whether she had a settled intention to remain in Italy permanently. It will be a question of Italian law whether she is subject to Italian tax, which is at a much lower rate than UK inheritance tax.

Calculating residence at time of death

If Mrs Pink was UK domiciled on death (for UK tax law purposes, and if necessary under the Treaty), then the critical question for the purposes of determining whether the £1 million is excluded property and therefore escapes inheritance tax is whether she was non-UK resident in the year of death.

There is a special rule for applying the ‘sufficient UK ties’ test in the year of death, contained in Finance Act 2013 Sch 45 para 20. This rule applies where an individual dies before 1 March, as per the above example. The overall effect of that provision is to treat the year of death as a mini-year and to adjust the day count requirements accordingly (Sch 45 paras 18 and 19). The other statutory residence text rule relevant to the year of death is the fourth automatic overseas test (Sch 45 para 15).

It is possible that in the year of death, the individual is neither UK resident nor resident in (say) Italy. Italian tax advice would be needed on the Italian position. They may be resident nowhere.

In Example 4, it may not be predictable how Mrs Pink’s residence or domicile position would ultimately be dealt with by the relevant authorities. The decision to move her liquid assets into FOTRA securities has the effect of protecting her inheritance tax position in the event that her estate was subject to UK (as opposed to Italian) inheritance tax, but that she was non-UK resident in that year.

Achieving non-residence

Any planning involving the use of FOTRA securities will necessitate an individual either being or becoming non-UK resident.

The requirement that the owner now merely be not UK resident has made planning with FOTRA securities a good deal easier than it was before 6 April 2013, when both residence and ordinary residence tests were difficult to operate. It is usually fairly clear under the statutory residence test whether someone is or is not UK resident.

For an individual to become non-UK resident in any given tax year, even if they have previously been UK resident for their whole lives, it is only necessary to ensure that they are not caught by the automatic UK residence test or by the sufficient ties test (Finance Act 2013 Sch 45 para 3). Under the sufficient ties test, the

threshold for the number of days spent in the UK needed to trigger UK residence is lower than for those who have not been resident in the UK in any of the three previous years (paras 18 and 19). However, non-UK residence can still be achieved even against a backcloth of long-standing prior UK residence.

Becoming non-UK resident may be easier after individuals retire, which is of course when their minds are likely to turn towards inheritance tax planning. They will no longer work in the UK, and thus no longer have a work tie. If their children are grown up, they will not have a family tie by virtue of having minor children in the UK. And if their spouse or civil partner becomes non-UK resident too, they will not have a family tie by virtue of their spouse remaining in the UK.