Foreign domiciliaries: the possible options for inheritance tax

Inheritance tax and trusts

21 June 2024

We consider the inheritance tax implications for non-doms with existing trusts as well as new arrivers of the current proposals on the table and the possible changes after the general election.

Key Points

What is the issue?

This article considers the inheritance tax options for non-doms with existing trusts and new arrivers (i.e. those who have not been UK resident in the previous ten tax years and have been UK resident for less than four tax years by April 2025).

What does it mean for me?

An option appropriate for one client will not work for another. Non-residence may not always be a complete tax answer from the inheritance tax perspective. However, any advice must remain uncertain until sight of legislation.

What can I take away?

Foreign doms can be forgiven for feeling that they are between a rock and a hard place at the moment. Hopefully, greater clarity on the scope of the new inheritance tax provisions can be outlined soon.

In the June 2024 edition of *Tax Adviser*, I considered the options for those who will lose the income tax and capital gains tax trust protections from April 2025. This article considers the inheritance tax options for non-doms with existing trusts and new arrivers (i.e. those who have not been UK resident in the previous ten tax years and have been UK resident for less than four tax years by April 2025).

The two major parties remain vague on the specifics of inheritance tax changes announced for non-doms. Although Labour and the Conservatives appear to agree on 90% of the March 2024 announcements, a key difference seems to be inheritance tax. Until an incoming government produces some legislation, it is not possible to give specific advice and practitioners should emphasise the need for caution before taking irrevocable decisions.

Assuming that the non-dom changes are not delayed and **are** effective from April 2025, there may be relatively little time for clients to weigh up their options between the publication of draft legislation and the end of the tax year. The legislation may well not even be final by the time the changes take effect – as occurred in 2008 and 2017!

This article highlights some issues that clients may want to consider in advance. An option appropriate for one client will not work for another. As explained below, non-residence may not always be a complete tax answer from the inheritance tax perspective. However, any advice must remain uncertain until sight of legislation.

The differences between Labour and the Conservatives

In the 2024 Budget, the government promised that all trusts established by foreign doms before April 2025 would effectively be grandfathered for inheritance tax purposes only and remain taxable under the current regime. This means that even where the settlor has become domiciled or deemed domiciled in the UK and however long they have been UK resident, any non-UK settled property held in a trust set up when they were foreign domiciled before April 2025 remains excluded property.

There are certain exceptions to this in relation to:

- settlors who acquired a foreign domicile of choice but were born in the UK with a UK domicile of origin and are now UK resident (‘returners’); and
- resettlements made after the settlor becomes deemed or actually domiciled.

However, the position was relatively clear and a long stayer settlor with a foreign domicile of origin who has now become domiciled in the UK could at least be certain that their trust remained protected from inheritance tax, provided that it held only non-UK assets and that the property was settled when they were foreign domiciled. It was proposed that if a non-dom died before April 2025, any trusts set up in the will would also be chargeable under the current regime.

The example of Arj below sets out the key differences between the current regime and the Conservative and Labour proposals.

Example: Arj’s discretionary trust

Arj was foreign domiciled and established and funded a discretionary trust in 1990 before he had acquired deemed domicile. In 2024, he is still resident in the UK and is now deemed domiciled. He may even have decided to settle permanently in the UK and has therefore acquired a domicile of choice here.

From April 2025, whatever his domicile status as a matter of common law Arj cannot benefit from the capital gains tax and income tax trust protections. However, provided the settled property comprises only foreign situated assets, under the Budget proposals there is no tax charge on his death, even if he can benefit from the settled property. There are no ten year charges. (Note that the trust does not have to avoid all UK situated assets. It can hold assets such as UK quoted shares in a foreign incorporated company.)

The settled property (being held by the trustees) will be non-UK situated and therefore excluded property for inheritance tax purposes. (There is , of course, one exception for enveloped UK residential property not discussed here.) On Arj's death, the trust can continue to be excluded property, thus providing indefinite and valuable inheritance tax protection for future beneficiaries whatever their residence or domicile status.

Differing approaches

Under the Conservative proposals, as Arj's trust was funded when he was foreign domiciled and prior to April 2025, no change arises to its inheritance tax status after April 2025. This was no doubt a pragmatic attempt to avoid problems of uncertainty (comparable to those seen in 2006 on the trust changes) if a foreign dom died before April 2025 when the legislation was due to come into effect.

It is perhaps not surprising that Labour objected to this permanent exemption. Labour's statement in early April noted:

> 'While Labour supports most aspects of the proposed replacement to the non-dom rules, including the four-year arrival window, the principle of a ten-year window for inheritance tax, we are concerned that major loopholes remain. That is why Labour will include all foreign assets held in a trust within UK inheritance tax, whenever they were settled, so that nobody living here permanently can avoid paying UK inheritance tax on their worldwide estates.'

It is not entirely clear what the reference to 'living here permanently' means. Assuming that Labour does not want to return to a domicile test, it **may** mean that someone who has been living in the UK for more than ten years will be subject to inheritance tax after April 2025 not only on their worldwide estate but also in respect of any property in trusts they have already set up.

And presumably (although this is speculative) they and their trusts will remain within the inheritance tax net for at least ten years after they leave ('the inheritance tax tail').

A fluctuating test

If this is right, the inheritance tax protection for existing trusts is no longer a permanent one but a fluctuating test (similar to that used for returners) which is retested at each chargeable event from April 2025:

- If the settlor is UK resident for more than ten years, the non-UK situated property is subject to inheritance tax.
- If the settlor has been non-UK resident for more than ten years, the foreign property will not be subject to inheritance tax.

Of course, there could be many other options used as a connecting factor for inheritance tax; for example, the residence of beneficiaries could be taken as the relevant connecting factor. However, most other tests pose even greater problems. The residence status of the settlor from time to time is surely the most likely test to be used, especially as it would appear it is intended to apply for trusts set up after April 2025 even under the Conservative proposals.

So in the case of Arj, not only would his worldwide personal estate be subject to inheritance tax from April 2025 (as is already the case if he is deemed domiciled here) but also the settled property would be subject to inheritance tax going forward from April 2025. Logically, this could mean that not only is the trust subject to ten year charges at up to 6% (with the first charge in 2030 in the example above) but if the settlor can benefit there would be a 40% charge on his death under the reservation of benefit provisions.

Assuming that the changes work in a similar way as for residential property in 2017, the rate would be 3% in 2030 (as the settled property would only have been relevant property for five years). Even if Arj leaves the UK in 2024/25 or later, the trust would still be within the inheritance tax regime if the relevant tie used is UK residence in the last ten years, as he will still have a ten year tail.

Objections to this approach

There have been vociferous objections to this proposal, usually on the following lines:

Unfair penalisation: Non-doms were tempted by the statutory reliefs around trust protections to set up trusts in 2017 and will now be penalised for doing so, suffering additional ten year charges. The trust could mitigate the ten year charges by investing in property qualifying for business property relief at least two years before the ten year anniversary. However, this may not always be commercially feasible and business property relief will not generally protect these trusts against a reservation of benefit charge arising on death. They are now in a worse position than UK doms who did nothing.

Winding up trusts: It is hard to wind up these trusts for deemed doms who are UK resident without incurring immediate income tax and capital gains tax charges. Should there be something equivalent to the temporary repatriation facility for such trusts which are wound up in favour of the settlor so that the rate of tax is reduced?

Spousal exemption: The inheritance tax regime as a whole is harsher than if they owned the assets personally. Not only are there ongoing exit and ten year charges but if the settlor can benefit from the trust, there is a reservation of benefit. In these circumstances, spousal exemption is very difficult to secure. Generally, business property relief is not possible to protect the person from a reservation of benefit charge on death (as it will only be available if the property qualified for business property relief when settled).

Unexpected benefits: Those who were UK domiciled when they settled property into trust and have been non-UK resident for more than ten years will unexpectedly benefit, as those trusts logically should now fall outside inheritance tax from April 2025!

Excluded trusts: It is assumed the new measures will not apply to trusts of settlors who have already **died** by April 2025. There are many very old trusts with excluded property status. It would be difficult to ascertain the residence status of the settlor (particularly under common law case law) in the years prior to their death if this occurred many years ago or to judge whether they were ‘living in the UK permanently’ at that point. But this is yet another point requiring clarification.

Options

In these circumstances what should Arj and non-doms in a similar position do to protect their inheritance tax position?

Option 1: Do nothing

Inheritance tax would be payable every ten years at 6% with the first charge arising in 2030 of around 3% (reduced slightly as it will only have been relevant property since 2025). That could be mitigated by a trust investing in business property for two years prior to the ten year anniversary (but the trust could not borrow to invest in business property and actually has to put the cash in two years before the ten year anniversary).

Inheritance tax would arise on Arj's death under the reservation of benefit provisions at 40% with no credit for the ten year charges and no possibility of business property relief. The trustees may be able to mitigate this by conferring on Arj a general testamentary power of appointment. He can exercise this by will to appoint his spouse or civil partner a revocable interest in possession, which could take effect as an immediate post-death interest (though he may not have a spouse or want to leave assets on trust for them). The assets are then in the spouse's estate going forward.

Arj may later choose to go non-resident to try and lose the ten year inheritance tax tail.

Option 2: Go non-resident

Arj must be non-resident for the whole of the tax year in which the trust is wound up and remain non-UK resident for six tax years. Split year non-residence will not normally protect the non-resident beneficiary from capital gains tax or income tax arising out of trust distributions in that year. In practice, it is unlikely now that Arj will be able to become non-UK resident for the whole of 2024/25, so the trust will not be wound up before 2025/26. At that point, there will be a small exit charge on the winding up of the trust as it is now chargeable property, though this will be very small. Arj can receive the trust assets tax free.

The real difficulty is that Arj will need to wait ten years before losing the inheritance ten-year tail. Under the current regime, deemed doms fall out of the inheritance tax net after three years, provided that they do not return within six years. Now Arj has

to wait for ten years and his estate is vulnerable to inheritance tax if he dies in that period. There have been objections to such a long ten year tail, although Germany has a similar tail. Both CIOT and STEP have suggested the tail should only be for the excess period over the ten years, so someone resident for 15 years here would only have a five year tail after they left the UK. It is hard to see an incoming government agreeing to this unless it can be shown that it will avoid a cliff edge (everyone leaving in the ninth year to avoid a ten year tail).

Arj can make gifts in this ten year period but:

- will need to survive seven years as he will be within the potentially exempt transfers (PET) regime; and
- cannot make gifts to UK residents out of trust distributions to him without the latter being caught by the onward gifts rule.

Therefore, he would generally have to wait three years before making a gift out of any trust distributions he has received received to avoid the onward gifts rule and seven to avoid inheritance tax altogether. He cannot set up another trust while still in the ten year tail without incurring an entry charge. Once Arj owns the trust property personally, he will have more options to secure business property relief or spousal exemption on his death and there are no continuing 6% charges. However, the ten year tail feels uncomfortable for an elderly person.

Some practitioners are hoping to rely on treaty relief. This will probably work in relation to a country like the United States, although most treaties refer to domicile as the deciding factor. However, it seems likely that treaty relief will be disapplied unless the other country has an effective rate of inheritance tax of more than 0%. In other words, the same approach may be followed as was adopted under Schedule A1. (Italy may therefore be a better option than India.) However, the earlier Arj leaves, the earlier he loses the ten year tail. This option will therefore be better for younger settlors.

Option 3: Arj as settlor stays UK resident but is irrevocably excluded from his trusts

Generally, only the settlor needs to be excluded to avoid a reservation of benefit and therefore avoid inheritance tax at 40% on their death for inheritance tax purposes. However, this would not avoid income tax on Arj if his spouse can still benefit. Exclusion will not avoid the 6% inheritance tax charges, which will continue while

the settlor is within the scope of inheritance tax, but it will avoid the 40% charge on death.

Ideally, exclusion is done this tax year while the settled property is still excluded property to avoid a seven year run off. Exclusion under the current regime in respect of foreign settled property should not generally give rise to a deemed PET under Finance Act 1986 s 102(4).

Arj's surviving spouse could benefit from trust property as a discretionary beneficiary after his death as his widow for both income tax and inheritance tax purposes without any ongoing income tax or inheritance tax charges for Arj.

This option is likely to be more suitable for the elderly settlor unlikely to leave. At that point, the trust really becomes a long term roll-up fund for the issue of the settlor. The trustees will want to invest in non-reporting funds to avoid any charge under the Taxation of Chargeable Gains Act 1992 s 86 on the settlor while he is alive and the UK resident children will have to accept income tax and capital gains tax charges on any distributions.

In conclusion

Foreign doms can be forgiven for feeling that they are between a rock and a hard place at the moment. Hopefully, greater clarity on the scope of the new inheritance tax provisions can be outlined soon.

The views expressed in this article are Emma's own and should not be attributed to the CIOT.