

UK Tax Planning - Foreign-domiciled individuals moving to the UK

A move to the UK presents foreign-domiciled individuals with a number of tax planning opportunities and pitfalls. This case study explores the options available to protect assets and maximise tax efficiency to preserve wealth now and for the future.

Mr Tchaikovsky (Mr T), a Russian domiciliary, is coming to live in the UK for a period likely to exceed seven years and is looking to structure his affairs in the most tax-efficient manner. His wealth amounts to approximately £20m in cash/investments.

THE FIRST SEVEN YEARS

THE REMITTANCE BASIS

Mr T can claim to use the remittance basis of taxation each year without the need to pay the £30,000 charge (although he will lose the benefit of his personal allowance and Capital Gains Tax (CGT) annual exemption).

In this period, an offshore trust can provide considerable advantages by deferring liability to CGT.

CREATION OF TRUST

1. Loan v Outright Gift

The trust could be funded either by an outright gift of foreign property (which would be excluded property for Inheritance Tax (IHT) purposes) or by a loan (ideally before taking up residence).

An outright gift of foreign property would be excluded property for IHT purposes. Although Mr T would have a reservation of benefit, the excluded property rules would take precedence. Note that if the foreign assets are gifted after taking up residence, and a capital gain arises in Mr T's hands, the gain will follow the asset and a later remittance by the trustees will be treated as a remittance of the gain by Mr T (this removes the pre-FA 2008 loophole whereby an asset was gifted onto trust but as there were no proceeds there could be no remittance of the gain).

Alternatively, a small initial settlement could be made followed by an interest-free loan to the trustees. The loan should not be a transfer of value for IHT purposes providing the agreement is correctly drafted. The loan route enables funds to be made available to Mr T in the UK without giving rise to capital payments. (See Deferral of Capital Gains Tax over the page)

2. Double Trust Structure

A further alternative which builds on the outlined planning in the above paragraph is for Mr T to settle two trusts. Trust One would receive a small initial sum, and Trust Two would receive a substantial sum of cash or cash and investments. Trust Two can lend the funds received to Trust One which then invests the money and generates income and gains which are kept separate. Trust One is then able to make loan repayments from time to time to

Trust Two in order that Trust Two can distribute money capital payments to Mr T in the UK (if required), with no tax implications on the basis that Trust Two is (and will remain) empty of income and gains.

This structure provides deferral of the tax due on any growth in value of Trust One (which will ultimately be payable when Trust One is distributed, subject to the residency position of Mr T at that time).

Mr T should ensure that the amounts loaned or settled do not include any post-5 April 2008 foreign income or gains arising while UK resident, as a remittance by the trustees (including investment in UK assets) would be treated as a remittance by Mr T as the trustees are “relevant persons” under the FA 2008 remittance rules. To the extent that the amount settled includes pre-6 April 2008 income, it should be noted that any remittances by the trustees for the benefit of Mr T (as settlor) will give rise to a tax charge.

SEGREGATION OF INCOME AND CAPITAL

Within the trust fund, income and capital can easily be segregated in order that remittances of income can be controlled. As with direct ownership, the settlor (unless both he and his wife are irrevocably excluded) will be taxable on the income, subject to remittance.

The taxation of trust gains under the capital payments regime is not by reference to the remittance of the gain itself but the remittance of the capital payment. As such it is not necessary to segregate capital and gains in a trust and gains can be “washed out” tax-free by making payments to Mr T offshore (providing they are not later remitted). Also, by carefully managing the timing and location of capital payments, tax deferral can be achieved on payments made to the UK.

In contrast, sale proceeds held personally naturally comprise both original capital and gain. Any “clean” capital should therefore be held separately from sale proceeds in order to avoid a tax charge on remittance.

DEFERRAL OF CAPITAL GAINS TAX

The trust will provide a deferral environment for CGT on the growth in value of the assets via the capital payments regime and also allows gains to be realised on UK assets without giving rise to an immediate CGT charge (contrast this to personal ownership). It should be noted that if UK property is held at trust level there may be IHT implications and to avoid this, such assets should be held by an underlying offshore company. This can lead to an element of double-counting of gains (a gain when the company sells the asset and another gain when the trust disposes of the company), but relief can be available in some circumstances.

A trust provides a double level of deferral of CGT – deferral until a capital payment is made and further deferral until such time as the capital payment is remitted to the UK. Alternatively, deferral can be achieved by using the Double Trust Structure, as outlined above.

Whilst the offshore trust rules impose a supplementary charge of up to a maximum of 60% of the CGT charge (effectively a “fee” for the deferral of payment of CGT), where capital gains arising are not taxed until a later year, the FA 2008 rules now match capital payments to trust gains on a last in first out (LIFO) basis, which may reduce the amount of the charge. At worst the maximum tax rate ultimately payable will be 44.8%.

FUNDS REQUIRED IN THE UK BY MR T

If the trust has been funded by loan, funds can be channelled back to Mr T in the UK as a loan repayment and providing the repayments are made from capital and not income, there will no tax implications (i.e. the loan repayment does not constitute a capital payment).

Otherwise, capital could be loaned interest-free by the trustees to Mr T in the UK, rather than distributed outright, thus reducing the amount of his capital payment to the annual loan benefit (currently calculated at 4.00% of the loan balance). This is particularly attractive if Mr T plans to leave the UK (for at least five full tax years) at some point in the future at which time the loan could be waived by the trustees with no tax consequences.

It should be noted that whilst Mr T cannot be taxed under the offshore trust anti-avoidance rules on a capital payment by reference to any undistributed income in the trust (on the basis that it is already taxable on him as settlor, subject to remittance), any UK capital payments or benefits conferred on other family members could be caught by this rule by reference to the income in the settlement that has not been taxed on Mr T because of remittance protection. To avoid this all income should be regularly paid away to Mr T outside the UK.

Alternatively, Mr T could consider using the Double Trust Structure, previously outlined.

AFTER SEVEN YEARS

REMITTANCE CHARGE

Once Mr T has been resident in the UK for seven tax years, he will be required to pay an annual £30,000 charge in order to access the remittance basis and thereby obtain deferral from Income Tax and CGT.

At this stage, Mr T could consider using an Offshore Insurance Bond to “wrap” the trust’s investments. However, if the bond is encashed whilst Mr T is UK resident the “event gain” is liable to Income Tax, and remittance basis is not a possibility for such a gain. Therefore, using an Offshore Insurance Bond is recommended where encashment can be delayed until Mr T leaves the UK.

It is possible for the trustees to receive up to 5% of the premium each year without giving rise to an event gain and this can be passed to Mr T as a loan repayment (or alternatively a capital payment in the UK, which should be tax-free (providing all previous (and future) trust gains have been washed out). If the Double Trust Structure is used, the 5% withdrawal received in Trust One can be paid to Trust Two as a loan repayment, and then distributed, free of tax, to Mr T.

INHERITANCE TAX

If Mr T is resident in the UK for more than 17 tax years he will be treated as deemed UK-domiciled.

If the trust has been funded by loan, the loan owed to Mr T by the trustees will be an asset in his estate. As a foreign-situated loan this will be excluded property whilst he is non-deemed domiciled. Thereafter, it will be chargeable in his estate. Thus, prior to the deemed domicile rule applying, Mr T should be advised to waive the loan to the trust. Any other foreign trust property (e.g. the growth in value of the trust fund) will be included in Mr T’s estate under the Reservation of Benefit rules but will be excluded property by virtue of his domicile status when the trust was settled.

If the trust was funded by outright gift, the trust property will be included in Mr T’s estate under the Reservation of Benefit rules but foreign property will be excluded property by virtue of his domicile status when the trust was settled. UK property should ideally be held at underlying company level to avoid ten-year charges and exposure under the Reservation of Benefit rules.

In contrast, if Mr T’s wealth was held personally, his worldwide assets would be exposed to IHT once he became deemed domiciled in the UK.

SUMMARY

	DIRECTLY OWNED	HELD IN TRUST
INCOME TAX	Foreign income taxable on remittance	Foreign income taxable on remittance
CAPITAL GAINS TAX	UK gains immediately taxed/ foreign gains on remittance – Need to keep “clean” capital separate for remittance purposes.	Deferral of tax on UK and foreign gains until capital payment is remitted or by using a Double Trust Structure - the loan route avoids the need for capital payments – No need to keep capital and capital gains separate.
INHERITANCE TAX	No protection for UK assets. Once deemed domiciled, worldwide assets are subject to IHT on death.	Trust’s excluded property status is preserved even after settlor becomes deemed domiciled. Can protect UK assets via underlying company.

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