Evidence Paper 8

Wealth Tax Commission

Defining the tax base – design issues

Author
Emma Chamberlain

The London School of Economics and Political Science
Warwick The University of Warwick
UKRI Economic and Social Research Council
Atlantic Fellows for Social and Economic Equity
CAGE

DEFINING THE TAX BASE – DESIGN ISSUES

Emma Chamberlain, Pump Court Tax Chambers

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1. Introduction

This paper is concerned primarily with two questions: *who pays wealth tax? and on what assets?* Although the answers to these questions may seem obvious – a personal net wealth tax is levied on a person's net wealth – they raise a number of issues. In relation to the question of *who pays:*

(a) Is the taxable unit the individual or the household? If the latter how do you define household? This is discussed in Section 2.

(b) The question of *who pays?* requires us to define the tax base more precisely by reference to both the residence of the taxable person and where the relevant assets are situated. These issues are discussed in Section 4.

(c) Does the taxable unit include vehicles that may be used to hold personal wealth – typically trusts, usufructs and foundations/private investment companies? Should such vehicles be taxed as separate persons in their own right or simply be regarded as another type of asset includible in the taxable base of the individual or household? This issue is discussed in Section 5.[1]

The answer to the questions of *who pays* and *on what* are clearly affected by the thresholds and rates used. How much wealth do you need before you start paying wealth tax and is there a limit to a person's total wealth tax liability? A high exempt threshold may solve a number of administrative problems including enforcement, valuation and liquidity.[2] But it can also create other problems concerning the taxable unit and avoidance behaviour from fragmentation of ownership. Section 3 draws the various elements together.

Section 6 considers the asset base of wealth tax. Like inheritance tax (IHT), wealth taxes in other countries have rarely been applied universally or at the same rate to all assets. The tax base is often narrow in scope.[3] For example, valuation discounts are invariably applied to the main residence;[4] other assets such as pension wealth are exempted altogether. 'Active' family businesses are often exempted or given preferential treatment.[5] These exemptions may initially be given to deal with legitimate liquidity or valuation problems or justified as a matter of principle.[6] They appear to end up undermining the validity of the tax as a whole. Not only is less revenue raised but those unable to benefit from such exemptions object to the tax more vigorously when it lacks horizontal equity. For example, the favourable valuation provisions applicable to land under German wealth tax contributed to its demise in the 1990s.[7]

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[1] The Irish wealth tax did treat private non-trading companies, often called family investment companies, as a separate taxable unit. However, in this paper we assume that the shares are brought into the taxable base of the individual/household; the issues here are not so much about *whether* to include them in the taxable base but rather about valuation, liquidity and fragmentation. The latter is discussed in more detail in Section 3.

[2] See Daly and Loutzenhiser (2020) on the effect of thresholds and rates in the context of valuation; and Loutzenhiser and Mann (2020) in the context of liquidity. Troup, Barnett and Bullock (2020) discuss thresholds in terms of administration.

[3] See Perret (2020).

[4] See Germany (Rehr, 2020), France (Tirard, 2020), Norway (Banoun, 2020), Spain (Ramallo, 2020), Switzerland (Eckert and Aebi, 2020), India (TA and Vanvari, 2020).

[5] See Spain (Ramallo, 2020) and France (Tirard, 2020).

[6] See Daly and Loutzenhiser (2020), and Loutzenhiser and Mann (2020) for a further discussion of valuation and liquidity difficulties.

[7] See Rehr (2020).

Moreover, as has been seen in the context of IHT where extensive and complicated reliefs are given to farms and businesses, every new exemption or relief introduces a new boundary which increases the incentives for avoidance and litigation.[8] An exemption may solve one problem only to create another.

Wealth tax generally applies to the net asset base (however that is defined). Hence debts owed by the taxpayer are prima facie allowable as deductions. However, experience in other countries such as France[9] suggests that debt is manipulated to avoid the tax. Italy taxes on the gross value of real estate, although its property tax (IMU) [10] is more akin to the annual tax on enveloped dwellings (ATED) in the UK[11]. What design solutions are available to reduce avoidance using debt while not creating unfairness? Section 7 addresses these issues.

[8] See Clark and Fu, 2020.
[9] See Tiraud (2020) and Dupas (2020). Although Advani and Tarrant (2020) note that wider evidence on the use of debt in tax avoidance is lacking, there were some comparable behaviours in the IHT world that were eventually stopped in 2013 and can be considered equally relevant to wealth tax.
[10] See Paoletto, Monte and Bonomi (2020).
[11] See Troup, Barnett and Bullock (2020) and Appendix A for further consideration of ATED.

2. Persons liable – who pays?

The individual or the household?

The 1974 UK Green Paper on wealth tax suggested that the natural unit of taxation for the purposes of wealth tax, at least from the social point of view, should be the family. This was justified on the basis that 'the family is the basic social unit in private life; and the long-standing rule for the aggregation of the incomes of husband and wife for income tax purposes...still has wide application and normally reflects the realities of the matrimonial situation' (ch.2, s.8). The argument is that the family as a whole is benefiting from the wealth in terms of better housing, access to better educational opportunities etc. The Irish Wealth Tax (1975–78) aggregated not only the wealth of the spouse and minor children with that of the husband but also that of a discretionary trust where the sole beneficiaries were spouse and/or children.

The OECD 2018 Report similarly noted in the context of wealth tax:

> *…there are strong arguments for using the family as the tax unit. If spouses were to be taxed separately it would be difficult to determine and split the ownership of household assets and to allocate the wealth of dependents to either one of the parents. In addition, in the case of a wealth tax with progressive rates and exemptions and deductions, taxing spouses separately would require closely monitoring transfers of assets between spouses.*

The Meade Report came up with conflicting criteria in debating whether to tax the household or the individual. On the one hand, Meade acknowledged that the decision to marry should not be affected by tax considerations and on the other claimed that two persons living together and sharing household expenditures can live more cheaply and therefore have a greater taxable capacity than two single persons living separately.

What do other countries do?

France, Norway, Germany and Switzerland all tax on the basis of the household rather than the individual although their exact approaches differ.[12] In some cases (Zurich and Norway), the exempt threshold (about £65,000 and £123,000 respectively) is simply doubled or at least increased on marriage but the couple are taxed as one unit and rates are determined by total household wealth.[13] Geneva does not distinguish between married and single taxpayers and a married couple receives no additional personal allowance and therefore suffers higher combined tax rates than two single persons. Ireland did not double the allowance: the exempt threshold for married couples was only slightly more than that of a single person but they were taxed as a single unit. Denmark and Sweden had the same exempt threshold irrespective of marriage or family size. In France, the €1.3 million exempt threshold for what was *impôt de solidarité sur la fortune* (ISF), and what is now the *impôt sur la fortune immobilière* (IFI) is not doubled if you marry[14]. Unlike any other country, France also includes cohabitees in the computation of household wealth.[15]

[12] See Rehr (2020). Compare Banoun (2020); Tiraud (2020) and Eckert and Aebi (2020)
[13] The same applied to Germany when WT was in force so that the €60,000 allowance was doubled. See Rehr (2020) For each minor child an additional allowance of €60,000 was added.
[14] See Tiraud (2020) – if they have a stable, continuous relationship which is publicly acknowledged.
[15] Tiraud (2020).

By contrast, Spain levies wealth tax on an individual basis and not on the family as a whole. With a high €700,000 personal allowance and an exemption for the main home of up to €300,000 per individual, this means that a couple resident in Spain may not pay wealth tax on assets of up to €2 million.[16] India adopted an approach of aggregating the wealth of the spouses only to the extent that gifts had been made by one spouse to the other.[17]

It might be argued that wealth is more easily aggregated by household for tax purposes where there is a community of property regime. France, Germany, Spain and Switzerland have community of property regimes where couples have broadly three options: complete separation of property; complete community of property with spouses jointly and severally liable for all debts; and community of assets acquired after marriage which is often the default position when a couple does not enter into a marriage contract. In these countries all but Spain use the family as the tax unit for wealth tax purposes but arguably this makes more sense as tax and property rights are aligned.

England and Wales do not have a matrimonial property regime. There is no presumption that a married couple own wealth jointly. There may be situations where the courts intervene to provide for the other spouse on certain life events such as divorce[18] or death[19] but that is simply an acknowledgement that a transfer of property is required to ensure fairness after a life event and in any event is at the discretion of the court and depends on a range of factors. It does not affect the ownership of property during the course of marriage which can be highly relevant where the wealthy spouse becomes bankrupt.[20] Freedman (1988) in *Independent Taxation: Lion or Mouse?* pointed out the difficulty in divorcing tax law from property law:

> …*it is difficult to devise and operate a sensible and coherent system of independent taxation when underlying property law does not make clear what are the respective interests of the spouses in any given property.*

The argument is essentially, why should one spouse be subject to higher rates of tax on their wealth because of their partner's wealth to which they may never have access or enjoyment?[21] It does not invariably follow (as the 1974 Green Paper suggests) that the taxable capacity of the family is simply the combined wealth of both partners.

However, it is not clear that the lack of a community of property regime is a strong enough argument for not taxing wealth by household. Moreover, the UK tax system is not consistent in its current approach. The UK Green Paper was published in 1974, before independent taxation. How does the UK system currently work?

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[16] Although there are significant regional differences as these allowances can be modified. See Ramallo (2020).
[17] See India (Ta and Vanvari, 2020)
[18] Matrimonial Causes Act 1973.
[19] Inheritance (Provision for Family and Dependants) Act 1975.
[20] Scotland has a modified separate property system: the general rule is that marriage does not affect the ownership of property although this is modified in some important ways e.g. a spouse has statutory occupancy rights in the matrimonial home, even if it is owned solely by the other spouse.
[21] Aggregation of wealth tax does not invariably follow in the case of community of property regimes or never follow in a non-community of property regime: Spain has a community of property regime but wealth tax is still levied on an individual basis, while Norway does not have such a property regime but taxes married couples together – although the exempt allowance is doubled.

What does the UK tax system currently do?

Income tax

The income of husband and wife is no longer aggregated for income tax purposes. They each have their own personal allowances and pay at progressive rates. They no longer receive an additional marriage allowance although in very limited circumstances £1250 of the personal allowance of one can be transferred to the other. To stop investment income splitting, the settlement rules in the income tax (Trading and Other Income) Act (ITTOIA) 2005 Part 5 Chapter 5 can apply to arrangements between spouses/civil partners where (broadly) the gifted asset is not an outright gift or is mainly a right to income and the donor keeps the capital value. In the context of spousal transfers, the settlements code has mainly been used to stop gifts of shares between spouses where profits can then be split between the two of them.[22] Where property is held in the joint names of husband and wife living together, it is assumed that the income of the property is divided equally between the spouses unless the spouses declare that they wish to be taxed according to their actual beneficial entitlements.[23]

Capital gains tax (CGT)

However, a married couple can only have one main residence between them for CGT purposes[24] and they can transfer property between each other on a no gain no loss basis while living together. This suggests taxation by household not individual. However, they each have their own personal CGT exemption and each individual is taxed at their own separate CGT rates.[25] Losses of one spouse cannot be set against gains of another. So some aspects of CGT operate on an individual basis.

Inheritance tax (IHT)

IHT is a similar mix. Transfers between spouses/civil partners are generally exempt for IHT purposes without limit.[26] (Before 1972 there was no spouse exemption at all under estate duty.) With the introduction of capital transfer tax in 1974, Healey introduced unlimited spouse exemption on all lifetime and death transfers citing it as a 'long overdue reform'.

Spouses/civil partners are taxed as separate individuals both on death and on gifts during lifetime each with their own annual exemption and nil rate band. Each individual has a nil rate band (£325,000) that cannot be transferred to the other spouse during lifetime and is renewed every seven years. However, on death the nil rate band *can* be transferred to the surviving spouse/civil partner. This, combined with the flat 40% rate, no longer makes splitting assets between couples to reduce IHT rates worthwhile.

In short, the UK tax system is the usual pragmatic compromise. Although the UK system notionally taxes the individual and not the household, the capital tax system certainly does not ignore marriage/civil partnerships and in some cases incentivises this form of relationship over cohabitation. How households are organised and whether they are married or not makes a significant difference to the IHT treatment in particular. See Example 1.

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[22] See *Jones v Garnett* [2007] UKHL 35.
[23] See Income Tax Act (ITA) 2007 s.836.
[24] And there are complicated rules on transfers of the main residence during marriage and on death
[25] Taxation of Chargeable Gains Act (TCGA) 1992 s.58.
[26] See s.18 IHTA 1984 – there is an exception for transfers to foreign domiciled spouses on wealth exceeding £325,000 although the foreign spouse can elect to be deemed domiciled here and obtain spouse exemption on gifts. See s.267ZA IHTA 1984.

Example 1(a) The married couple with joint assets of £1 million

Married couple John and Janet die. They each have cash of £175,000 and jointly own a house worth £650,000 (£325,000 of the house each). They have made no lifetime gifts. Janet dies leaving everything to John. John then dies with an estate still of £1 million leaving everything to their children. No business property or farm is owned.

Current IHT position – there is no tax payable on either death. Janet's estate on her death is covered by spouse exemption. John's estate is covered by two nil rate bands and two residential nil rate bands. All unrealised gains are wiped out on death. Assets are rebased to market value on each death.

Total tax is nil.

Example 1(b) The cohabitees.

As above except Janet and John are not married. On Janet's death before John, £175,000 of her estate is taxable at 40%= £70,000. Her £500,000 estate gets the benefit of the nil rate band of £325,000 but not the residential nil rate band as the house and her remaining estate do not pass to issue but to John. On John's death shortly afterwards, his total estate is worth £1 million less £70,000 tax paid on Janet's death = £930,000. There is then further tax payable. After deducting John's residential nil rate band and transferable nil rate band, the chargeable estate is £430,000 at 40% = £172,000 tax.

Total tax is £70,000 + £172,000 = £242,000

If Janet had left her estate on discretionary trusts with John and the children as beneficiaries, John's estate would have reduced by £430,000 leaving no tax to pay on his death and £70,000 on Janet's death. The current system encourages this sort of planning.

Points in favour of taxing by household

If wealth is freely transferable between spouses/civil partners in the CGT and IHT context, there is an argument that wealth tax should similarly be calculated by reference to the wealth of the household rather than the individual; otherwise fragmentation of wealth is more likely to occur – particularly if the exempt threshold is high and rates are progressive. Avoidance opportunities are obvious. See Example 2.

Taxing on a household rather than individual basis is normally assumed to bring the administrative advantage of requiring only one return. However, the tax could be *computed* by reference to the joint household wealth but *paid* separately with individual liability and separate assessments. [27]

[27] This would work a little like the IHT treatment of certain types of life interest trusts. On the death of the life tenant, IHT is computed by reference to the combined total of his free estate and the value of the trust assets in which he has a life interest. Any available nil rate band is prorated between the free estate and trust fund and then liability split accordingly. This requires separate trust and personal forms on death to be completed.

Example 2

Assume the exempt wealth tax threshold is £500,000 and that wealth tax is charged at a flat rate of 1%; wife (W) owns £900,000 and husband (H) owns £100,000. There are four options:

(1) Aggregation by household (as per France) without doubling the threshold results in 1% on the joint wealth above £500,000. Tax payable is £5000. H and W then pay total tax presumably calculated in proportion to their wealth.
(2) Doubling the exempt threshold but taxing by household (as per Germany and Norway) results in nil tax.
(3) Separate taxation (as per Spain) would result in W paying £4000 and H nil. W could transfer £400,000 to H and they would both own £500,000 and pay nil.
(4) Partial aggregation (as per India) but separate taxation would only require H's £100,000 to be aggregated with W's wealth if W had given it to H. W would then pay £5000. Otherwise the position is as in (3) above and there is no incentive for W to give to H.

Aggregation would avoid dispute and uncertainty over who owns what.[28] Instead of having to work out which spouse owns what property or whether joint property is owned 50/50 or 80/20 the individual position will be irrelevant to the computation of the total wealth tax liability (although it may be relevant in determining how the tax will be borne within a household. See below).

The household approach is adopted generally in the welfare system and for student loan entitlement which is affected by the cohabitation status of the parents.

It makes the operation of an alternative minimum tax of the sort suggested by Summers (2020) easier. All households within scope of the tax would be required to pay a minimum total amount in tax calculated as a percentage of their total wealth. If the household already paid more than this amount in other taxes then there would be no additional tax to pay. Obviously if the assets were owned by one spouse and the income earned by another this approach would suggest a household basis of taxation is required, otherwise the high earning spouse with assets held in the other's name will not benefit from the overall cap unless it was accepted that the high earning spouse also had to own the valuable assets.

Similarly, some countries such as France operate a ceiling provision so that wealth tax and income tax due from the same household cannot exceed 75% of the previous year's income. Taxing on an individual rather than household basis would lead to greater avoidance by ensuring the person with the low income would own the valuable assets.

If household wealth is to be aggregated, consideration needs to be given to spouses with different residence status, not an uncommon occurrence among wealthy couples. For example, one spouse/partner works abroad full time while the other stays in the UK, often to educate the children. Split residence between husband and wife is easier to achieve in the UK than in

[28] See the recent case of *Moutreuil v Andreewitch*, 2020 EWHC 2068 Fam for difficulties in agreeing who owns what. Both parties had claimed full ownership of the company, which also owned their £2 million former family home, with Andreewitch arguing that Moutreuil was no more than a bare trustee or nominee who held the shares for him on a common intention constructive trust. It was held that the cohabitee Moutreuil was beneficially entitled. It is curious how often people transfer assets to a spouse or cohabitee 'for tax purposes' without accepting that beneficial ownership has therefore passed. Presumably evidence of who has been paying wealth tax in the interim would assist in resolving disputes on beneficial ownership later!

countries like Germany and Norway where a home that is used by the family unit is often sufficient to establish residence.[29] Switzerland operates a system whereby the non-resident spouse does not pay Swiss wealth tax on non-Swiss assets but their wealth is taken into account in calculating the rate of wealth tax imposed on the wealth owned by the Swiss resident.[30]

Points in favour of taxing each individual separately rather than the household

If the tax unit is anything other than the individual, this raises certain definitional problems which must be considered carefully:

(a) Should cohabitees as well as spouses be included in the definition of household? If so, how should cohabitation be defined?

(b) What about adult children living at home? Or minor children? How do step children fit into the picture? The position of children can be dealt with separately from the position of whether to tax the household or the individual and is discussed later.

(c) Should all wealth of couples (whether married or cohabiting) be aggregated and taxed at the highest rate and if so who pays; how is the liability split? Even if taxed as one unit, could the liability for the tax be prorated between members of the family and taken from their respective pots of wealth? Who is actually responsible for filing the return and paying the tax?

Dealing with the latter point first: tax could be computed on the basis of the household even if liability is shared pro rata. However, taxation by household, from the HMRC perspective would likely favour joint and several liability, otherwise HMRC are into the business of working out who owns how much of what. This loses one significant advantage of taxing by household (see discussion of aggregation above). Furthermore, if the liability is prorated between the couple in proportion to their individual wealth, this will require two returns or at least two assessments. Similar issues arise in the context of IHT where for example the executors of an estate can be personally liable for IHT on assets that never come into the estate or under their control simply because it is easier for HMRC to collect the IHT due from the executors than the donee.[31]

However, joint and several liability, while administratively easier, may prove unacceptable for taxpayers. Why should one spouse be liable for the other's wealth tax liability? What happens where individual A has high value assets (e.g. a family company) but no liquidity and individual B has lots of savings or income that are effectively then used to pay the wealth tax of the other? It may not fairly reflect how property ownership is in reality divided, particularly if on divorce B is allocated no stake in the company of A on which B has paid wealth tax.[32] Even if the tax is computed by reference to the household wealth but liability is prorated, B has paid more wealth

[29] See Appendix B for definition of residence.
[30] See Eckert and Aebi (2020).
[31] Although the liability of the executors in respect of reservation of benefit property is limited to the value of the estate that comes into their hands under s.204(9) IHTA the liability is necessarily computed by reference to property that never comes into their hands at all. So if A gives a house to B and reserves a benefit, with A's remaining estate passing to their widow/widower on death, the tax due on the house on A's death can be taken out of the estate passing to their widow/widower and there are only limited rights of recovery against B.
[32] It is by no means certain or even likely that a court would award B half the family company shares in this case. This is where the lack of a community of property regime in the UK compared with say Switzerland could make a material difference to the way in which wealth tax liabilities can be collected.

tax due to assets owned by A (the family company) from which B may derive no personal benefit. So in practice household taxation may not be as administratively easy as initially thought.

Taxing only married couples/civil partners but not cohabitees as one unit may be seen as unacceptable given the increase in cohabiting couples in the UK and the number of quite complicated arrangements. However, bringing in cohabitees as part of the tax base of the household raises definitional problems. The OECD 2018 Report acknowledged this when it noted that joint taxation would usually only be an option for spouses/civil partners not cohabitees even if the difference might be difficult to justify from the perspective of horizontal equity. Only France operates wealth tax on households that include cohabitees. Generally, the UK tax legislation distinguishes between married couples/civil partners and unmarried couples and does not attempt in other areas to tax cohabitees as part of a single household.[33]

In response to this issue, it could be said that in the social security system, both tax credits and benefits are calculated by reference not only to the circumstances of the married couple but to the 'family'; the term 'couple' includes spouses and unmarried couples living together. As HMRC already has to consider whether an unmarried couple is living together as husband and wife for the purposes of tax credits, it could presumably do the same for wealth tax. After all, HMRC cite a number of signposts such as living in the same household; stability of the relationship; financial support; sexual relationship; dependent children and public acknowledgement for the purposes of tax credits.[34] So it would appear that it is not impossible to define the cohabitee if the decision is to tax on the basis of household wealth.

Nevertheless, leaving aside whether it is possible to identify the household unit (which may involve some intrusive questions over some domestic living arrangements), taxing by reference to household or individual is not purely a question of tax avoidance or taxable capacity; it also raises wider issues about independence, privacy and interdependence of the spouses/cohabitees.

For example, the design of the current welfare system has itself been strongly criticised because forming family units can lead to a loss of benefits and greater financial insecurity. Suggestions to encourage behaviours conducive to family stability by removing some of these disincentives of cohabitation and increasing the financial independence of claimants living together have fallen on deaf ears:

> *Disaggregation – operating the welfare system according to the same principles of individual and separate treatment as applies to the income tax system – would cancel out many of the disincentive effects to co-residential partnering highlighted in this research… However, each time such a proposal has been advocated, it has been unequivocally rejected…a more modest reform would be to allow newly cohabiting couples a period of grace of living together of perhaps 6 or 12 months before joint assessment was imposed.*[35]

The same points would be relevant for tax. Even if aggregation of wealth by household is feasible in stable long-term situations it will be harder in more mobile families or where relationships are more complicated; many of the same problems seen in the welfare system around definition,

[33] Most parts of the UK tax code that currently refer to cohabitees do not as such require the taxpaying partner to investigate the income or wealth of their cohabitee. Their status is simply a relevant factor in determining whether additional tax arises on the taxpayer or for certain other anti-avoidance reasons.
[34] See HMRC Tax Credits Manual TCTM 09345.
[35] See Griffiths (2017). https://www.cambridge.org/core/journals/journal-of-social-policy/article/no-love-on-the-dole-the-influence-of-the-uk-meanstested-welfare-system-on-partnering-and-family-structure/2F239C7174C8CC56F3CDC10A9FA6004C/core-reader

changing circumstances, and deterrents to forming family units are likely to be replicated here. For example, someone might split up from their spouse in order to live with another person for six months before finding themselves single again. Is aggregation to be determined by someone's status at a particular point in the year e.g. 5 April being the end of the UK tax year, irrespective of their marital position for the majority of the previous or next year? These are not insurmountable points, but they would certainly make administration more complicated particularly where tax returns are typically filed by reference to past events.

A person may be unwilling to disclose details of their wealth to the spouse/cohabitee, even if they are happy to do so to HMRC. Aggregating the wealth of couples for the purposes of determining rates, even if they remain separately liable to pay the tax, may therefore be seen by some as a retrograde step on these softer issues quite apart from its practical difficulties.

Aggregation of household wealth is less necessary where there is a low exempt threshold and flat rates. To take a simple example, if the exempt threshold is (say) £300,000 with a 0.1% rate the tax loss is relatively slight if one spouse chooses to divide their £1 million wealth so that each spouse owns £500,000. But if the wealth tax starts at £1 million per individual with steeply progressive rates, fragmentation may become more relevant and this would lean towards aggregation of the household wealth.

Even if the threshold is high, as Advani and Tarrant (2020) note, the splitting of wealth to avoid or reduce tax may not be as significant as sometimes thought although the evidence is not entirely clear and it will depend on a variety of interrelating factors. For example, would transfers of wealth to minimise wealth tax give rise to other taxes such as capital gains tax or inheritance tax? These issues would need to be considered carefully in the design of wealth tax.

Taxing wealth by reference to the individual rather than household (as Spain does), is on the face of it simpler administratively. However, it may be seen as unfair if, as is the case in Spain, wealth per household of up to £2 million can effectively be sheltered from wealth tax. However, even if you tax wealth by household, it would be difficult to ensure that the tax position is wholly neutral between people who live alone vs together or where adult children live with their parents or separately. For example, it would be unfair for the wealth of two individuals to be eroded faster because they had married or cohabited than if they had stayed single.[36] Doubling the tax exemption threshold for married couples involves a trade-off. If the threshold is not doubled, couples face a wealth tax disincentive to get married. If the wealth tax exemption is doubled and tax is by reference to households, there is an advantage to marriage when one partner is well below the wealth threshold as the richer party is better off, having now doubled the threshold at which their wealth starts to be taxed.

A hybrid solution?

It is sometimes suggested that an individual system of taxation could be adopted but the wealth of the spouse/cohabitee would be aggregated to the extent they had acquired it by gift from the other spouse/cohabitee. This was the solution adopted in India, presumably to cut down on avoidance. If they are both independently wealthy, then no aggregation occurs. While superficially attractive, this presents a new set of problems. Aggregation only if there has been a gift by one person to another is difficult to police.[37] Will all inter-spouse transfers have to be

[36] France did not double the allowances and this led to resentment. Germany did and Norway does double the allowances for married couples who are taxed as one unit.
[37] It has not been straightforward even in relation to the settlements income tax legislation, where at least there it is easier to track the particular income paid to the spouse where the capital value of the asset is retained by the donor.

valued to check they are at market value? Who is going to keep track on how much has been given and whether, if the recipient spends money they are treated as spending the gifted money or their own money? Will there be any time limit or will a record have to be kept for ever? None of this sounds very practical, most countries give complete exemption between spouses partly for practical reasons and the question is whether the mischief justifies all this complexity.

UK capital tax rules effectively exempt most gifts between spouses for CGT and IHT; this at least has the merit of simplicity.[38] The US imposes rules to track gifts to 'alien' i.e. non-US spouses by US persons. Judging from the websites of various US advisers these rules seem to create new opportunities for avoidance behaviour.

Minor children

Irrespective of whether you tax the individual or the household, the position of minor children needs consideration. There are a number of options here:

(a) As Spain does, tax each minor child independently with the benefit of their own exempt threshold and at their own personal rates. This obviously encourages fragmentation, but that is less of a problem if there is a low exempt threshold and a flat rate. It has the considerable merit of simplicity: each child is separately assessed to wealth tax (even if the parent is responsible for the return) with the tax payable out of the child's wealth.

(b) Aggregate all the wealth of the unmarried minor children with that of their parents, irrespective of source, on the basis that a wealthy child relieves the parents of certain financial obligations. This stops fragmentation but as noted below, can result in unfairness and complexity.

(c) Aggregate the wealth of the unmarried minor child with the wealth of the parent but only to the extent the parent gave them that wealth. This follows the current income tax settlement provisions[39] which treat income arising to the minor child as the parent's over £100 per annum but only if the property was gifted by that parent.[40]

The suggestion in the 1974 UK Green Paper was vague: the child's wealth would be aggregated with that of the parent from whose side of the family the wealth was derived. This might have been easier to operate in a world where family structures were simpler than now. The following issues must be addressed in less straightforward familial situations:

(a) Suppose a child is living with one parent but the wealth is derived from the other parent who may have little contact with that child. Is the child's wealth aggregated with that of the donor parent (as with the income tax settlement provisions) or with the person with whom the child lives (who arguably most directly benefits from the child's wealth)? If the former, how will the liability be settled: from the child's fund or by the parent direct (Switzerland follows the latter course). The donor parent is not deriving any direct benefit from the child's wealth

[38] And gifts between spouses fall largely outside anti-avoidance provisions such as reservation of benefit – see Finance Act (FA) 1986 s.102(5) although note that gifts between spouses of different domicile can raise issues.
[39] ITTOIA 2005 s.620.
[40] For income tax purposes where income arises on an asset gifted by grandparents to a grandchild the grandchild is taxed on the income with the benefit of full personal allowances and lower rates etc. It could be objected that it is easy to avoid by say A giving property to his nieces and nephews on the basis that the parent of the nieces and nephews gives property to A's children. The income tax settlement provisions already stop this sort of avoidance given the wide definition of 'arrangement' and similar provisions could be incorporated for wealth tax.

if not living in the same household but on the other hand they may be receiving indirect benefits by being relieved of financial obligations towards the child.

(b) What if that parent or step parent with whom the child is living has no income of their own but the wealth of the child is aggregated with that parent not the donor? Presumably then the wealth tax would be funded directly out of the child's wealth. However, if the parent or step parent had wealth just above or below a particular threshold or band, the child's wealth could put them into wealth tax liability where otherwise there would be none or impose a higher rate of tax. See Example 3.

(c) Even if the total liability is prorated between the child and the relevant parent with whom they are living, unfairness could arise if the parent does not in practice have access to the wealth and it is just retained for the child until 18.

(d) A child may be living with both parents who nevertheless live in separate households. A set of rules is needed to work out how aggregation works.

A simpler route is for aggregation to follow the current income tax settlement provisions which are limited to gifts from the parent. The wealth of the child would be aggregated with that of the parent irrespective of whether they are living together but only if the parent is the donor. Otherwise the child's wealth is taxed separately on the child. This avoids:

(a) problems of a parent being taxed at a higher rate on their own wealth simply because they have a wealthy child where that parent may know nothing about the gifts they have received from a grandparent, friend or deceased relative (including the other parent).

(b) undue complexity where there are more complicated family situations such as step children and second marriages or joint custody.

Irrespective of how and to whom the child's wealth is aggregated, presumably aggregation would occur only for the purposes of calculating the rate of tax. *Liability* for the tax itself would be prorated between the child and relevant parent. The tax would then be paid out of the child's wealth (with exempt thresholds and access to lower rates split pro rata to the overall joint wealth). In practice this may not be easy where the child's wealth is illiquid – e.g. family company shares. Secondary liability could fall on the parent to whom the wealth is aggregated.

Example 3 illustrates the various options.

The minor child may have a different residence status from the donor parent. If liability for tax on the child's wealth is imposed on the donor parent then logically the liability should follow that of the parent's residence status. This would avoid problems where a minor child is at a UK boarding school and therefore resident here but the parent is not UK resident and may have no other connections in the UK.

Example 3

Giles has one child, Anna, and one step child, Cathy; they all live together. He was married to Jordan who has now died. Cathy is Jordan's child by an earlier relationship. Giles' wealth is £600,000. He has given Anna cash of £20,000. Anna has also inherited £500,000 from her parent Jordan. Cathy has inherited £500,000 from Jordan. Assume the exempt threshold per individual is £500,000. The rate of tax increases over £1 million.

There are three options:

(1) Tax each child separately from Giles (as per Spain). Cathy falls within the exempt threshold. Anna pays tax on £20,000. Giles pays tax on £100,000.
(2) Aggregate the wealth of each child with that of Giles (as per Switzerland). Giles pays tax on an aggregate value of £1.520 million. The total bill will be prorated between him, Anna and Cathy in accordance with their respective wealth, but Giles will effectively pay at a higher rate on his own wealth.
(3) Aggregate the wealth of each child to Giles only if he gave them the property (as per UK income tax settlement provisions). Giles pays tax on £120,000. Anna and Cathy are exempt as their remaining wealth falls within the exempt threshold.

Example 4

Facts as in example 3 above except that Anna and Cathy (both under 18) are in a UK boarding school and Giles is living in Switzerland (and paying wealth tax there). Anna and Cathy are UK resident.

There are three options:

(1) If each individual is taxed separately, Anna pays tax on £20,000. However, Giles would pay Swiss wealth tax on the total household wealth.
(2) If the wealth of the children is aggregated with Giles then no UK tax arises as he is not UK resident – see section 4. He would still pay Swiss wealth tax.
(3) If only the £20,000 gifted to Anna is aggregated to Giles, then Anna and Cathy are prima facie liable to wealth tax in the UK but fall within the exempt threshold here. Giles would appear to be liable to Swiss tax on the total household wealth.

3. Tax exemption thresholds, rates and caps

This paper makes no recommendations on either the rate at which wealth tax should be levied or the exemption threshold. However, the rates and exempt threshold have significant effects on certain design features. This section briefly summarises the issues.

Rates and thresholds

Tax exemption thresholds have varied significantly across countries. In France and Spain there is a high exemption threshold – €1.3 million for France per household[41] and €700,000 for Spain per individual (with an additional € 300,000 for the house so effectively exempt thresholds for a couple can be € 2 million). Typically, a high threshold usually goes with higher rates (1.5% top rate in France, 3.45% top rate in some areas of Spain).[42] In Switzerland and Norway, with arguably more successful wealth taxes, the exemption threshold is low with lower, flatter rates.

In 1974 the UK Green Paper proposed a hypothetical exemption threshold of £100,000 (equivalent to about £1 million today) and a starting rate of 1% increasing to 2% over £300,000, 3% over £500,000 to £2 million[43]4% from £2 million to £5 million and 5% over £5 million (£500,000 being equal to about £5 million today).

A single flat rate applying across a broad band of taxpayers and starting at a relatively low threshold reduces the incentive to fragment or divide wealth between different entities or persons such as spouses/children/trusts and therefore reduces the need for complicated (and sometimes ineffective) tax avoidance legislation. Fragmentation becomes an issue if the threshold is high or the rates are progressive. This is illustrated in Section 2 in relation to the choice of tax unit but also has wider ramifications when considering trusts (see Section 5). Put simply, a wealth tax that is steeply progressive with a high initial exemption poses greater opportunities for avoidance by fragmentation, as people are encouraged to split wealth between members of the family (and trusts) to take advantage of lower rates and exemptions.

While low exempt thresholds and flat rates have attractions in terms of fragmentation, a high tax exemption threshold combined with higher rates is often justified on the grounds of equity: only the very wealthy pay the tax and the potentially distortive effect of wealth taxes on modest savings is reduced. A high tax exemption threshold also has the significant benefit of limiting administrative and compliance costs. In particular, HMRC has the resources to check valuations properly simply because it is doing fewer of them; high volumes of taxpayers are not overwhelmed with the need to value all their assets.[44] Problems of liquidity may also be seen as less pressing in relation to a high exemption. For example as Loutzenhiser and Mann (2020) note, the problem of the single retired person living in the big house with little income is removed if the threshold is £2 million but is significant at £500,000. However, they also show

[41] Prior to the abolition of wealth tax but a similar threshold operates now just in relation to real estate in France.

[42] In Germany the rate was 1%; in France the rate increases to 1.5% over €10 million; in Spain the rates vary between 0.20% to 2.50% at a national level but some regions such as Extremadura have set higher rates of up to 3.45% for taxable wealth over €10.9 million.

[43] This was one of the possible thresholds suggested for "illustrative purposes" only and "not intended as an indication of the exemption limit or the rates at which the tax might be introduced". The other set of bands used in the examples was 1% from £100,000 to £500,000; 1.5% from £500,000 to £2 million; 2% from £2 million to £5 million and 2.5% over £5 million. See Chapter 1 of Green Report.

[44] See Daly and Loutzenhiser (2020).

that while the *volume* of liquidity cases may be reduced, a high exempt threshold does not remove liquidity problems in relation to more valuable farms and businesses.[45]

A high tax exemption means that most taxpayers will never need to value their assets at all as they will obviously be below that limit. This will reduce compliance costs. The OECD suggested in 2018 that a net wealth tax could still raise significant revenues even if the exemption threshold is set at a high level provided that the tax base is broad with few exemptions. That is the model that has been suggested recently in the US.[46] The argument is presumably that a high threshold may reduce the need for reliefs and discounts in relation to particular assets. However, this is not borne out by international experience: France, Norway, Switzerland and Spain all have very different rates and thresholds but all give similar discounts to the main residence and, in fact, Norway and Switzerland (low rate/low threshold) give less preferential treatment to businesses and have fewer reliefs. Higher exempt thresholds do not seem to produce a broader tax base – possibly because wealthy elites may find it easier to press quietly for an exemption (See Perret, 2020).

Caps on wealth tax by reference to income

Ceiling provisions or tax caps are common features of net wealth taxes – usually introduced to deal with liquidity issues (For a fuller discussion see Loutzenhiser and Mann, 2020). The caps operating in Europe are by reference to income rather than total wealth. They sometimes consist in setting a limit to the combined total of net wealth tax and personal income tax liability as a maximum share of income. In France, the wealth tax ceiling limits total French and foreign taxes to 75% of taxpayers' total income. In Spain, the aggregate burden of income tax and net wealth tax due from a Spanish resident cannot exceed 60% of their total taxable income although there is also a floor provision requiring a minimum of 20% of the net wealth tax as originally calculated to be paid. Seven out of twenty-six Swiss cantons have some form of cap based on wealth tax payments as a share of total taxable income. Norway does not have a tax cap.

Linking wealth tax to taxable income in this way can create significant opportunities for tax avoidance as revenues can be manipulated and there are incentives to reduce income.[47] For taxpayers whose tax liability is at or above the tax cap, owning more wealth does not result in more tax. But an increase in income will raise the tax cap and thus increase the wealth tax liability. If a wealth tax is intended to tax capital because the benefits of owning that capital are not adequately reflected by taxing the income it produces, it seems odd to cap it by reference to the amount of total income. One might as well stick to taxing income – possibly with a surcharge on investment income – and avoid a wealth tax altogether. This was indeed the option chosen by Labour in 1974.

An alternative floated by Summers (2020) is to use a wealth tax as an alternative minimum tax (AMT) effectively serving as a backstop for income tax and CGT. All individuals within scope of the tax would be required to pay a minimum total amount in tax calculated as a percentage of their wealth. If the individual already paid more than this amount in other taxes,[48] then there would be no additional tax to pay. In effect, this is equivalent to giving relief against wealth tax for those who already pay a lot of other taxes e.g. because they have a high income. It does not of course deal with liquidity concerns: rather the opposite. Unlike the French model, the wealth tax is paid by those who actually have less taxable income and it still requires the estate to be

[45] See Loutzenhiser and Mann (2020).
[46] Saez and Zucman (2019); Saez and Zucman, (2019b); Batchelder and Kamin (2019).
[47] See Advani and Tarrant (2020), Section 3.4 in comments on Spain's behavioural response.
[48] Presumably only UK taxes not foreign taxes would be taken into account.

valued and disclosed in order to ascertain whether the alternative minimum tax is applicable at all.[49]

Caps related to total wealth – what do other countries do?

Switzerland and Italy provide special regimes for the wealthy immigrant which enables them to cap their total liability to all taxes by a lump sum payment. In Switzerland this is called the 'forfait'. It is not available in all cantons, cannot be used by Swiss citizens or those married to Swiss citizens or who work in Switzerland, must be negotiated in advance and is not fixed but varies according to the person's wealth calculated according to a formula. It is not time limited. A person within the forfait does not pay Swiss wealth tax. So in effect it is a system open to non-Swiss wealthy immigrants but operates outside the Swiss wealth tax system.

Since 2016, Italy has offered the Impatriate Article 24 regime. It is open to Italian nationals as well as non-Italians but all claimants must have been non-Italian resident for the previous 9 out of 10 years. Unlike Switzerland it can only be claimed for a maximum 15 years. No income tax, wealth tax, gift tax or IHT is due on foreign assets, gains or income. Foreign income and gains can be remitted without tax to Italy. All this can be secured by a fixed fee of € 100,000 per annum payable[50] irrespective of actual wealth. *Imposta di bollo* (the property tax on Italian real estate) remains payable along with Italian tax on Italian source income and gains.[51] So this system operates partly within the existing Italian limited 'wealth tax' system.

No European wealth tax system as part of its *wealth tax design* offers a cap based on the total amount of capital. Could such an approach work for the UK?

Banding and a lump sum cap – 'the ATED Type Approach'

Troup, Barnett, and Bullock (2020) consider the administrative advantages of a banded approach combined with an effective maximum cap (called here 'the ATED Type Approach') and Daly and Loutzenhiser (2020), and Loutzenhiser and Mann (2020) consider the implications of such an approach in terms of valuation and liquidity in detail. The nearest equivalent of the banded/capped approach in the UK are ATED[52] and council tax. ATED effectively combines bands with a cap: all houses worth more than £23 million pay a flat rate of £236,250.

To summarise, the ATED Type Approach can:

(a) assist liquidity for those with very high wealth, particularly where the wealth is tied up in a single asset such as a company which appears to be more likely at higher levels (See Loutzenhiser and Mann, 2020);
(b) reduce the need for valuation by the very wealthy – they just pay the fee without worrying about what their assets are worth at all. It does not necessarily assist those with wealth at lower levels and can seem unfair if you fall into the lower end of a wide band;
(c) assist compliance and protect privacy at the top level – the very wealthy and HMRC do not need to get into lengthy discussions each year as the taxpayer is paying the maximum amount anyway;

[49] It would probably assume a household basis of taxation for the reasons mentioned in Section 2.
[50] With an additional €25,000 for each other family member.
[51] For details of rates and valuation see Paoletto, Monte and Bonomi (2020). Note that most main residences are exempt unless 'luxury' it is levied on a gross not net basis and the rate is about 0.76%. The values used are usually significantly below market value.
[52] For rates etc. see Appendix A of Troup, Barnett, and Bullock (2020).

(d) reduce avoidance as there will be a positive disincentive to split wealth among trusts and other vehicles if the very wealthy individual can pay a maximum lump sum;
(e) ensure simplicity.

However, there are clearly some serious objections to the ATED Type Approach when applied to wealth tax more generally as opposed to just a limited class of residential property. These include but are not limited to the following:

(a) Setting the maximum cap and the bands is likely to be controversial and subject to political football;

(b) Bands may be perceived as unfair by those of lesser wealth at the lower end of each band;

(c) Bands do not necessarily deal with valuation or liquidity problems for the moderately wealthy;

(d) The maximum cap seems to favour the very wealthy and may cause resentment both from those below the cap and those above it. It breaches horizontal and vertical equity. Should someone with £50 million of wealth pay the same as someone with £1 billion? If the wealth tax starts at a low level, the middle class may well feel that they are paying proportionately much more than the extremely wealthy who can use the tax cap. That may suggest a high exemption threshold is necessary. However, Switzerland has a low wealth tax threshold but also a forfait available only to foreigners. 5,150,529 Swiss taxpayers – mostly middle class – were liable to net wealth taxes in Switzerland in 2016 and they were not subject to any maximum amount.[53] It is not known how much resentment there is towards those foreigners who can use the forfait arrangement;

(e) Some of the design problems of a wealth tax remain unresolved. For example, it does not solve the problems of double taxation for those such as US citizens who continue to pay US tax while being subject to a wealth tax. It may result in different avoidance behaviour by encouraging aggregation of wealth at the top level so one person pays a single maximum amount which could be less than the total of two people paying lower amounts separately.

Like Portugal, Spain,[54] Italy, France[55] and Switzerland, the UK offers some tax incentives for those newly arrived in the UK through a system called the remittance basis (see Appendix B). Presumably, such tax incentives for arrivers are given for reasons of political economy: all governments want to attract wealthy foreigners. However, whether regimes like the forfait or tax cap should be extended more generally to all wealthy people living in the UK in the context of a wealth tax is a rather different matter.

[53] See OECD 2018 report.
[54] Ramallo (2020).
[55] France provides a wealth tax exemption on foreign assets for the first five years of residence.

4. Territoriality: connecting factors.

A common objection to wealth tax is that it will lead to emigration of the wealthy (see Perret 2020). Furthermore, it is said that a country with a wealth tax may deter people from moving here in the first place. This section examines briefly the evidence for these objections and then considers in more detail whether any design solutions could be adopted.

The effect of wealth taxes on emigration and immigration

Advani and Tarrant (2020, Section 3.7) suggest that the migration response in terms of leaving the country altogether or coming here in the first place may be relatively small.[56] However, they suggest that differential wealth taxes between different regions within the same country can (at least in relation to Switzerland and Spain[57] where the rates and exemptions vary quite considerably) lead to significant migration between regions.[58] David Duff in *The Abolition of Wealth Transfer Taxes* (2005) is persuasive that a failure to integrate federal and provincial taxes properly can (a) lead to higher administrative and compliance costs and (b) can undermine the tax base altogether leading to eventual abolition. In his view, looking at Canada, Australia and New Zealand, it is preferable to operate a federal/national system of capital taxes to stop migration between regions and a race to the bottom. National wealth taxes have generally been the norm in most countries that have or have had net wealth taxes including France, Norway, Denmark, India, Ireland and Austria.[59]

Liability to wealth tax – how do countries decide who is to pay wealth tax and on what?

Firstly, every country has to work out the territorial limits of its tax base. A government cannot impose wealth tax on everyone in the world. How does it determine liability? The key connecting factors here are generally **residence of the individual/household** and **situs of the assets.**

All countries with a wealth tax impose wealth tax on real estate held directly by the non-resident person or through companies owned directly or indirectly by such non-resident person;[60] some

[56] See also Brülhart et al. (2017).
[57] In Spain, the structure and design of the wealth tax is regulated by the central government with national rates set of between 0.2% to 2.5%, but the regions have power to change both exemptions, minimum thresholds and rates. Hence, Madrid has set up a tax deduction amounting to 100% of the tax while some regions such as Andalucia have increased tax rates over the national rate (to 3.03% over approximately £9.5 million wealth). The entire revenue from wealth tax is allocated to the regions. See Ramallo (2020).
[58] It should be noted that some cantons such as Zurich which have lower rates and higher exemptions do not operate the forfait. Geneva does have a forfait option and its wealth tax rates for those who do not qualify for the forfait start at 0.175% and increase to 0.450% for wealth over about £1.373 million; Zurich has a higher threshold exemption with rates starting at 0.05% and increasing to a maximum of 0.3% for wealth over about £2.6 million. See Eckert and Aebi (2020).
[59] In Norway the net wealth tax is split into a national and a local component. The total rate is currently 0.85% of which 0.15% passes to the national government and 0.7% to the municipality. The municipalities have power to levy a lower rate than 0.7% although only one has chosen to do so. See Banoun (2020), Norway.
[60] See, for example,Norway and Switzerland.

countries such as Spain and Germany also impose wealth tax on bank accounts and other investments situated there and owned by non-residents.[61]

Generally, all such countries tax residents of their country on worldwide wealth but some such as Spain and France provide periods of exemption for immigrants. Norway, Switzerland and Germany do/did not. All countries generally impose no wealth tax liability on non-residents on assets situated outside the country (except in relation to foreign companies owning real estate situated there) but some such as Germany, India and Spain have a tail so that wealth tax on a worldwide basis is/was imposed annually on the non-resident for a minimum period after departure. France, Switzerland and Norway do not do this. As noted above, all countries impose wealth tax on non-residents in respect of real estate in their country, whether directly or indirectly owned.

Broadly consistent with the above, the 1974 UK Green Paper proposed that someone who was both UK resident and domiciled here would be liable to wealth tax on his worldwide assets. Non-residents would not be within the charge to wealth tax except possibly on the value of UK land or assets held in connection with a permanent establishment in the UK. UK portfolio investments were specifically *not* to be subject to tax on non-residents wherever domiciled. Although many countries on the Continent give non-residents a lower exemption threshold than residents, and they are charged at different rates, this was not proposed in the Green Paper. By implication, given the current system as it then operated for foreign domiciliaries in relation to IHT, the practical result of the Green Paper would have been to ensure that foreign domiciliaries living long term in the UK for up to 17 years would not have been charged wealth tax.[62]

The UK tax position – territoriality: the current connecting factors used in the tax system

By territoriality we mean the connecting factors that the UK currently uses when taxing (a) those who have been UK resident all their lives (b) those who were UK resident but have left and (c) those who have never been UK resident but then become UK resident.

The current approach to territoriality in the UK tax system for income tax, CGT and IHT purposes is set out in some detail in Appendix B. It is fair to say that the UK tax law is a mess in this area. While prima facie it would be sensible for wealth tax to use the same connecting factors that operate for income tax, CGT and IHT, even a brief review suggests that the present regimes are hardly a desirable place to start (and in any event are not consistent with each other).

Nevertheless, many would regard it as over complicated to ignore domicile in relation to wealth tax and use an entirely different set of connecting factors. This may be particularly true if IHT is retained in its current form alongside a wealth tax. Some people might be liable to both taxes, others to neither and some to one and not the other. It might be easier to 'game' the system if very different rules operate between these taxes.

So how could a wealth tax work if the current system was adapted? The current IHT regime may superficially seem the most relevant regime with which to align a wealth tax: after all, IHT is a tax on transfers of wealth, wealth tax taxes the ownership of wealth. How then does the current

[61] See Rehr (2020) on German and Ramallo (2020) on Spanish position and note that treaty relief may partially relieve the position. Compare IHT which does, subject to treaty relief, impose tax on the UK estate of foreign domiciliaries including UK shares. See Appendix B, Section 1, footnote 2.

[62] This was the route followed by capital transfer tax that was the precursor to inheritance tax.

IHT system work? Broadly, anyone domiciled in the UK, wherever resident, is subject to IHT on their worldwide wealth. Anyone domiciled outside the UK, wherever resident, is not subject to IHT on their non-UK wealth unless they have been UK resident (since 2017) for more than 15 out of the last 20 years. Anyone domiciled outside the UK who has been in the UK for more than 15 years remains subject to IHT on worldwide wealth for at least 3 and up to 6 years after leaving (see Appendix B for further details).

However, IHT is a once in a lifetime tax and the individual who is domiciled or deemed domiciled here is likely to have spent a significant proportion of their life in the UK. The same point does not necessarily apply for annual taxes such as wealth tax. For example, it would be odd to impose an annual wealth tax on someone for many years after they had left the UK simply because they had not lost their UK domicile under common law. IHT does do this but at least there is some network of treaties particularly with the US that can relieve double taxation – and it is a one-off tax on death. An annual wealth tax that was imposed by reference solely to someone's domicile would mean that an individual could end up paying an annual wealth tax on his US wealth even though he has never set foot in the UK simply because neither he nor his father has settled in a particular US state. See Example 11 in Appendix B for the particular oddity of how this would work.

If IHT is rejected as a suitable model then it may be better to bite the bullet, so to speak, and just have a more rational system, and hope that the other taxes are eventually aligned with that model. However, some may object that as an annual tax the current connecting factors used in income tax and CGT are the ones that should be applied to a wealth tax. How would this work? Domicile is relevant to income tax and CGT but only if you are UK resident (see Appendix B). If this model was adopted and the individual was domiciled abroad but UK resident you would be subject to wealth tax only on UK real estate or capital remitted. If non-resident your domicile would be irrelevant and you would only pay wealth tax on UK real estate.

However, this system is not very desirable or simple. What about capital that is brought to the UK and then taken out again by the foreign domiciliaries? Would this be subject to wealth tax once remitted? That would certainly be an additional deterrent to UK investment. Would foreign domiciliaries be subject to worldwide wealth tax if here for more than 15 years (as is the case with income tax and CGT)? And would the current trust protections that operate for foreign domiciliaries who put assets into trust also be applicable for wealth tax? Currently if the foreign or UK domiciliary leaves the UK they are not subject to income tax and CGT. Would the same rule operate for wealth tax purposes or should a tail operate similar to that for IHT on worldwide wealth where even a foreign domiciliary pays IHT for at least the first three years after departure?

Perhaps most relevantly, domicile as a tax connector in the current international age has become increasingly difficult to apply on any practical basis. Section 3 of Appendix B sets out the difficult case law in determining the basic question of where someone is domiciled. The long list of questions in Appendix B and the recent lengthy HMRC enquiries and case law on domicile illustrate the difficulty of applying this concept to taxation. Domicile may once have worked when people generally stayed put in a country for the longer term. It is difficult to apply in the tax context with international families and frequent moves.

To some extent, this reality is already recognised in the tax system because foreign domiciliaries who have been UK resident more than 15 out of the last 20 tax years are 'deemed UK domiciliaries' for tax purposes. However, even then the tax position is not quite the same as for an actual UK domiciliary. Examples 13 and 14 in Appendix B set out some simpler scenarios but even these are hardly straightforward.

To sum up, a series of political compromises on foreign domiciliaries has created complexity and inconsistency in the tax system. If any of the current approaches adopted for IHT, income tax or CGT purposes worked, then there would be a good case for adapting them to wealth tax. But few would agree that the current system has much to commend it. Domicile is therefore positively rejected as a relevant connecting factor in the context of wealth tax. It should be wholly ignored in relation to the taxation of individuals (and will therefore, as we see, be largely irrelevant to the taxation of trusts). What alternative connecting factors should be used?

Alternative connecting factors for the UK that could be used for wealth tax

As noted above, other countries with a wealth tax operate a relatively simple system: essentially the sole connecting factors are residence and situs, with some countries operating 'tails' to tax you after you have left for a minimum period after departure; others operate a period of exemption when you first arrive there provided you have not been resident there previously.

Is such a system sensible for the UK? What other connecting factors could be used to determine liability to a wealth tax? The 1988 HMRC Consultation on residence and domicile suggested that the tax system should satisfy the following criteria:[63]

(a) Fairness and equity – those whose connection with the UK is limited should pay less 'than those with more permanent and substantial connections here'.

(b) Neutrality – 'it should not needlessly discourage people from coming to live and invest in this country or encourage people already living here to invest abroad to leave; any incentives provided by the tax system for particular groups of taxpayers or in relation to certain types of income, should be intentional and specifically targeted.'

(c) Simplicity and certainty – 'the rules for determining liability should be as clear as possible and based on objective tests. The taxpayer should be able to ascertain his position reasonably quickly and easily and should not have to incur undue expenditure in complying with the law. Similarly the rules ought to be readily applicable by the tax authority with the minimum administrative cost.'

    [Author's comment: that rules out domicile then!]

(d) Enforceability – 'Whatever rules are laid down should be capable of being reasonably enforced'.

The 1988 paper was focused mainly on the difficulties of determining residence under the pre-2013 system, although it also noted the capricious and inequitable effects of domicile. Since then, the Finance Act 2013 has introduced much greater certainty about when someone is UK resident for tax purposes by introducing a statutory residence test – but domicile remains even more difficult to apply in the modern world. Is, therefore, residence alone a sufficient connecting factor in the UK for the purposes of a wealth tax?

It is relatively easy for people to spend quite considerable amounts of time in the UK and still not be UK resident. Unlike countries such as France and Switzerland, it is possible to have your main home in the UK (provided you also have a home elsewhere) and spend up to 180 midnights

[63] These criteria are taken from the excellent 1988 consultative document on residence and domicile published by HMRC – none of which recommendations were adopted then! See Part 1 section 3.2

in the UK without being UK resident provided the family is not UK resident.[64] It is common for non-residents to spend up to 120 midnights in the UK each tax year although 90 midnights may be more typical. These are quite lengthy periods and if residence alone is used as a connecting factor, such persons would not be subject to wealth tax except on UK assets. Is residence alone sufficient or should some other connecting factors also be used?

The 1988 paper rejected citizenship as a suitable connecting factor to determine the extent of an individual's tax liability, although not all its reasons seem justifiable today. The US is still the only major country which uses citizenship as the main test of liability. It is certainly a more objective and certain test than domicile, but it is not clear why citizenship alone should be a reason to impose wealth tax if the individual is not actually resident here. Residence still seems a fairer connecting factor at least in relation to a wealth tax. British citizenship can apply to those who have never set foot in the UK; should they be subject to an annual wealth tax? This would be a much more radical change for British citizens living abroad than the recent introduction of CGT on non-residents holding UK real estate. At least there they have a choice as to whether to buy or sell UK land. Imposing wealth tax on the worldwide assets of British nationals wherever they lived would have a more radical retroactive effect, particularly if there was a charge on giving up citizenship.

The 1988 paper suggested an 'intermediate basis of taxation' which would operate for a limited period of years (7 out of 14 was suggested) for people who first become UK resident. Either it could apply only to those who were also foreign domiciled (Option 1) or the concept of domicile could be dropped altogether and it would simply be 'fiscal connection' (Option 2): 'Any individual who was resident in the UK and had not been resident for 7 out of the previous 14 years would then be liable to tax on the intermediate basis'. That is more like the current system but it is not clear that these intermediate systems of taxation are very satisfactory. In the end, residence still seems the simplest connecting factor and the only question is whether to have an exemption for those who are here for short periods and a tail for those who leave.

With that lengthy introduction four questions then have to be answered:

(a) How should people previously non-UK resident be taxed when they arrive in the UK – the entry point.

(b) How should people be taxed if they leave the UK?

(c) What assets should be included in the tax base of those who are non-UK resident? All UK situated assets or just UK real estate?

(d) What other design issues arise for non-residents?

It is assumed of course that those who have always been UK resident and remain so will be subject to a wealth tax on a worldwide basis. Domicile will not be relevant.

The entry point

Should all UK residents be subject to the same level of wealth tax irrespective of how long they have been in the UK? France and Spain offer reliefs for the first five or three years respectively after arrival.

[64] See Appendix B for a full survey of the rules.

The UK Green Paper Report (ch.2, para.13) noted:

> *It would not be reasonable to charge a person to the same extent if his ties here are less permanent and someone who is resident and ordinarily resident and who has not lived here for a considerable period might be made liable to the charge only on the total value of his assets here.*

The policy reasoning for exempting non-UK assets from wealth tax for new arrivals is not spelt out in the Green Paper. There are certainly good arguments for exempting the non-UK assets of new arrivers from *inheritance tax*. A new arriver coming here for a temporary work placement for three years might feel aggrieved to find themselves subject to the risk of 40% IHT on their worldwide estate if they were unlucky enough to die here within those three years particularly where all the wealth had been acquired prior to UK residence.[65]

However, the arguments for exempting new arrivers from wealth tax are less convincing. Given the wealth tax would be an annual charge payable only while UK resident, unlike IHT levied at 40% it would not unduly deplete worldwide wealth. Nevertheless, from the practical perspective it would be onerous to require a person intending to be resident here for only a limited period to have to disclose their worldwide wealth. For a person who intends to reside in the UK for a limited period, the requirement to provide detailed valuations and disclosure of their worldwide estates (not an inexpensive exercise particularly if it involves trusts) may be a significant disincentive to become UK resident in the first place. (However, evidence of this is mostly anecdotal and further investigation is desirable.)

Residence raises particular issues in relation to a one-off wealth tax discussed elsewhere. It might be seen as especially egregious for a new arrival to pay wealth tax on 'old capital' when he has had no previous connection with the UK and equally unfair for a leaver to have escaped such a one-off tax just because he happened to have left the UK a year or two previously. These principles of fairness would need to be considered carefully if a one-off tax was adopted.

Assuming we are talking about an annual rather than one-off wealth tax, the options are as follows:

(a) No relief – everyone pays wealth tax on a worldwide basis from the moment they arrive – this is the approach adopted in Norway.

(b) Forfait type option - new arrivers have the right to elect to pay a maximum capped amount for a minimum period in exchange for non-disclosure of foreign wealth. In short this would be akin to a remittance basis charge but would not be dependent on domicile (see Appendix B).

(c) Exemption option – new arrivers could be exempt for a maximum period after arrival on all non-UK assets. This is the French approach.

[65] Hence foreigners who have not come to the UK with the intention of settling here permanently (foreign domiciliaries) have always been exempted from UK taxes on foreign property for a minimum period (currently 15 years). See Appendix B. The length of that period of exemption remains subject to continued political debate. As also noted in Appendix B the uncertainty of domicile as a concept in taxation and the introduction of a series of deemed domicile rules for long stay residents suggests that it is not necessary to use domicile as a connecting factor.

(d) A phased approach. The longer you are in the UK the higher the proportion of worldwide wealth is brought into taxation. (However, this would require disclosure and valuation of worldwide wealth from the start.)

However, if an option of complete exemption for foreign assets or a cap like a forfait is adopted for new arrivers, further questions arise. Example 5 sets out some options.

Example 5

Ajaz is newly arrived in the UK from the US. He intends to return there after two years and is currently working for a US bank in London. There are four options:

(1) Pay an annual tax on his worldwide wealth like all UK residents in which case he would have to disclose and value it. Possibly if he became resident halfway through the year a split year approach could be adopted to charge him at half rates.
(2) Pay a fixed forfait amount each year. After the first few years he would then be subject to wealth tax on a worldwide basis.
(3) Exempt him from wealth tax on foreign assets for a fixed period and limit the wealth tax to UK assets.
(4) Tax him on increasing amounts of worldwide wealth over a phased period.

The above raises a number of questions:

(a) If a fixed forfait amount of some sort is to be paid for the first few years should it be possible to change that forfait election each year or should it be a once and for all decision made in the year of arrival? You may want to be taxed on a worldwide basis if your wealth suddenly falls in value.

(b) Should exemption be available only to those who have never previously been UK resident? Or should it be available to all new arrivers, even returning UK citizens provided they have been non-UK resident for a minimum period? The latter approach moves away from the idea that only foreign wealthy people should be given tax breaks and might encourage some UK citizens to return but what sort of minimum period of non-residence should operate before they receive the exemption/forfait on return? Six years non-residence might be the minimum requirement before you could get any wealth tax breaks on return.[66]

Equally, this sort of option would encourage wealthy UK individuals to manipulate matters so they never pay wealth tax on their worldwide estate at all. They do six years non-residence and then return for the maximum period allowed to claim exemption on non-UK assets before leaving again! There is some evidence that since 2017 foreign domiciliaries are doing precisely that to reset the clock for claiming the remittance basis.

(c) If a forfait is offered rather than outright exemption on non-UK assets, the level at which the fixed fee is set would have to be considered carefully. Presumably it should be set at the higher end of the amount typically payable by individuals. However, there is a trade-off. If set too high, then for the majority of people the forfait provides no relief at all. If too low, it is a giveaway to the very wealthy.

[66] This adopts in some form the current rules for foreign domiciliaries/and (slightly different) non-residents.

(d) The question of how this would relate to trusts where the new arriver is settlor or beneficiary must also be considered. Would a trust funded prior to the settlor arriving in the UK also be exempt from disclosure and payment of wealth tax for the first five years after the settlor arrived here? Or would the settlor's personal exemption have no impact on his trusts? This will depend largely on the connecting factors used for trusts which are discussed in Section 5.

(e) If a forfait is applied, should UK assets still be charged? If a forfait is not applied and non-UK assets are exempted, should wealth tax operate for new arrivers in the same way as for non-residents. i.e. only on UK real estate and property-rich vehicles with all other UK assets exempt?

(f) Crucially, how long should the tax break (whether exemption or forfait) for arrivers last? Or should full tax on worldwide wealth be phased in over a period of years as in 4 of Example 5.

All of this complicates the design aspects considerably and it must be debateable how far these options are really necessary.

Another consideration is how wealth tax should operate for those who are dually resident. This matters principally where the other country has a wealth tax and the person is liable to wealth there. Although it would be possible to apply treaty tiebreaker provisions to resolve residence in favour of one country, negotiating wealth tax treaties may not prove straightforward. To deal with this issue, it is possible that the primary UK legislation could simply provide that where someone is resident in another country under a treaty AND subject to wealth tax there, then the UK's taxing rights are limited to real estate here.

How should wealth tax operate for those leaving the UK?

The next question is whether emigrants should escape wealth tax from the moment they become non-UK tax resident. Presumably residence or non-residence would be judged by reference to their status on the relevant filing date. So if the filing or assessment date was 5 April each year, their residence status would be judged by reference to whether they were non-resident or resident at any point in that tax year (with relief possibly given where split year residence applies). The statutory residence rules are set out in Appendix B and are relatively easy to operate. Unlike domicile, taxpayers generally know with certainty whether they are UK resident or not under domestic law although determining treaty residence under the tiebreaker provisions can be more challenging.

The options here are as follows:

(a) Complete exemption from the tax year you become non-UK resident. See France, Norway and Switzerland. This is simple and certain.

(b) A tail could be imposed on those who leave for a minimum period after departure. Wealth tax would continue to be imposed on a person's worldwide estate each year for a certain number of years. The person would file a wealth tax form each year based on the value of the estate each year. This option operated for India and Germany and is effectively how Spain works. The principles to justify such a tail would need to be considered carefully. However, it would aim to capture in some way the wealth that someone has accumulated while in the UK but may be only fully realised after departure e.g. a sale of the company that finally occurs a year after departure. Equally it would probably need to be backed up by a gift tax to stop people immediately gifting their wealth after they have left.

(c) An exit tax based on the value of your wealth when you leave. It could be levied on the value of your estate when you leave at a higher rate but spread over some years. However, as Example 6 illustrates, both (b) and (c) raise some issues of unfairness and complexity. No countries have imposed an exit tax on wealth. Some countries impose CGT when the person leaves on the basis that the increase in wealth over the period of residence should be captured on departure. However, other than Canada, European countries have struggled to enforce exit taxes successfully, not least because they are in breach of EU law.[67]

(d) A temporary non-residence rule similar to CGT and income tax purposes. These currently require someone who has been living in the UK for more than four out of the last seven tax years and then leaves, to remain outside the UK for more than five years. If they return within that period then most gains and some income realised while non-UK resident are taxed at the rates prevailing in the year of their return.[68] A similar device for wealth tax purposes would require the leaver who has been resident here for more than four out of the last seven tax years to remain outside the UK for more than five years[69] to avoid wealth tax being levied in the year of their return presumably cumulatively for all past years. Again there seems no rationale for such a policy. People can defer realisation of gains or income until they are non-UK resident. In relation to wealth, people either have it or they don't – they cannot manipulate it in quite the same way. There is no logical reason why they should be charged cumulative wealth tax on return. A wealth tax designed in this way would also require the returning individual to obtain valuations for up to five years retroactively. That would be an onerous task particularly if there have been disposals and changes in the asset base or deductible liabilities during that non-resident period.

[67] In relation to both the tail and the exit tax, it could be argued particularly in relation to people who have been born here and then leave that they should pay some special tax on departure – but unfairness could arise. However, they will have paid wealth tax throughout their lives so why impose an exit tax? The arguments might be different for IHT which has not been paid annually and does have a long tail. An exit tax has the distinct disadvantage that it does not capture and tax properly changes in wealth – up or down – that occur shortly after a person has left.
[68] The temporary residence rules do not apply to all gains and income and only apply if the person has been UK resident for four out of the seven years prior to leaving.
[69] In practice it is usually six years for income tax and CGT or five years and a split year.

Example 6

In Example 5 above Ajaz ends up staying ten years in the UK before moving to Switzerland where he works for a bank in Zurich. Assume that wealth tax is 1% per annum. After departure the options are as follows:

- Exemption – he is immediately free of UK wealth tax from the first complete year of non-residence – this is simple.
- Tail – he pays tax for a minimum period, say three years, at 1% on the value of his wealth each year. His wealth is revalued in each of those years. If he receives a large bonus payment or significant sale proceeds after leaving then the wealth is taxed for a short time thereafter. On the other hand he might give the wealth away and escape wealth tax.
- Exit tax – he would pay tax on the wealth valued at the date he leaves – with say 3% levied payable over three years. But if the wealth increased in value shortly after leaving (e.g. due to a large sale) that wealth would not be captured, and if it had decreased Ajaz would pay too much. However, any gifts Ajaz made after leaving would not affect the exit tax.

Enforcement of either exit or tail options may prove problematic.

Consideration would need to be given as to whether his UK wealth tax liability is creditable against his Swiss wealth tax liability. Given valuations and reliefs are likely to operate on a different basis, the position could become very complex quite quickly.

If Ajaz died in the second year, the tail would presumably no longer be payable but the exit tax would have been paid. Is it refundable? Or is wealth tax payable on his estate for the three years?

On what assets should non-residents pay wealth tax?

If it is accepted that non-residents (subject to the points above), only pay tax on assets located within the UK, the third question is what UK assets held by non-residents should be charged? In most countries wealth tax on non-residents is generally limited to real estate in the country, owned directly by the non-resident individual or indirectly through a company. Quoted or unquoted investments, personal items or cash situated in that country are not taxed if owned by a non-resident. The 1974 Green Paper took a similar approach. That can be justified pragmatically for two reasons:

(a) It is unhelpful to discourage foreigners from investing in the UK. Real estate is a more scarce resource but the UK presumably wants non-residents to continue to invest in the UK economy. Norwegians object that this gives foreign inward investment a competitive advantage. It is unclear whether this is a material problem in practice.

(b) In practice a wealth tax on movables can be relatively easily avoided anyway by the well-advised simply resiting the UK assets. For example, instead of owning a picture, UK share or UK bank account directly the non-resident individual can without much difficultly move the asset into a foreign incorporated wholly owned company. We call this ‘enveloping’. Although the IHT legislation has stopped this sort of enveloping in relation to UK residential land, it would be much harder to do so in relation to other types of property.

Other design issues

The fourth aspect relates to general design issues – some of which have been considered above. For example, should the non-resident be subject to a higher rate of tax and have a lower exempt threshold than a UK resident on his UK assets? The Green Paper did not suggest this, but some countries restrict reliefs. For example, most restrict relief for debt; Spain and France do not offer the tax cap to non-residents. The recent stamp duty land tax (SDLT) changes will impose a higher rate of SDLT on residential property purchased by non-UK residents. Should non-residents also pay higher wealth tax on UK residential property?

5. Trusts/foundations/usufructs and estates

For a basic understanding of trusts and other vehicles it will first be necessary to read Appendix A.

Introduction

The general principle often stated is that no tax advantage or disadvantage should follow from holding assets in trust rather than giving them to an individual. Trusts, say HMRC in their 2018 consultation, should be neutral for tax purposes. However, this is easier to state than achieve. Neutral in comparison to what? Comparing a gift to a trust with an outright gift to an individual with retaining outright ownership is difficult. The individual who receives the gift or retains outright ownership has full ownership and control.[70] A gift to a trust confers control on the trustees – the people who hold the property, but does not give them the right to benefit from the property. There are three players in a trust scenario: the settlor, the beneficiaries and the trustees and the various powers, benefits and controls they may each retain or receive will vary considerably from trust to trust. They may each be resident in different jurisdictions, each with their own rules.

Trusts are therefore fundamentally different from outright gifts. For example, if I give away shares to my children, they own and control an asset which can be valued. The shares may produce little income or have restricted rights on sale or liquidation but all these points can be taken into consideration when valuing what the children own. Even if I give away my house to my children and continue to live in it at their discretion, the house still belongs to the child and can be taxed on them if they are UK resident.

By contrast if I give shares away to a discretionary trust and exclude myself from benefit or die, it is not clear who should be taxed and on what basis. If I cannot benefit or control the trustees, why should I be taxed apart from the fact that I chose to make the gift in the first place? I may have given the shares away many years ago and have little involvement now. It is very likely that the original terms set out in the trust deed may have been changed by the trustees to take account of different beneficiaries and different circumstances. The trustees may or may not act in accordance with the settlor's wishes.

Equally if I as settlor am UK resident but am excluded and no UK resident beneficiary receives any income, capital or other benefit from the trust fund why should they be taxed on it? Some people may well not even know that they are beneficiaries. That leaves the trustees as the third possible player but then on what basis should they pay wealth tax: by reference to the residence of the settlor, beneficiaries or trustees?

This paper concludes that the residence status of the settlor is *relevant* in determining whether a trust fund should be subject to wealth tax in the first place: after all, a settlor has a choice on how to make his gift and whether to give to children outright (with no further wealth tax liability if they are non-UK resident) or into a trust for their benefit (where we suggest there will be ongoing liability). However, the notion that every settlor should be taxed on the assets of the trust fund irrespective of whether he can benefit or control the trust is rejected. It is rather arbitrary, prone to manipulation and does not look at what is often a more nuanced reality.

[70] This is often stated but in fact is over simplistic. In many cases an outright gift itself e.g. of minority shares can be subject to a series of fetters and restrictions that mean the individual has very far from outright control.

It is therefore not simply a matter of working out how to value trust interests or the underlying trust assets and including them in the wealth tax base of any person who happens to be UK resident, whether settlor, trustees or beneficiaries. The basis of how to allocate that trust wealth and to whom must be considered first. One must then consider when and what trust assets will be taxed. In fact, it seems improbable that an outright gift and a gift into trust should be taxed in the same way or that the tax treatment could be neutral between them. They are totally different animals and one is not comparing like with like. Neutrality does not therefore seem a very sensible objective and the current UK tax system does not in the end achieve this. It is a pragmatic compromise with a few arbitrary results.

This section first looks at how other countries tax trusts, then considers briefly how the UK taxes trusts at present. We then look at the options for taxing trusts as a matter of principle in the UK and then when and how to allocate trust wealth to settlor/trustees/beneficiaries. A summary of the conclusions is found at the end of this section.

How do other countries tax wealth held in trusts?

The European countries with a wealth tax do not typically use trusts as a common means of ownership. Other ways of splitting control and benefits are used such as usufructs and foundations.[71] The tax system for such entities in civil law countries operates quite differently from the UK and is not necessarily very effective or transparent.

Where trusts are used, some countries such as France, Spain and to a lesser extent Switzerland, tend to tax the settlor to wealth tax on the value of the trust assets. If the settlor is resident there, then wealth tax is paid on all the assets by the settlor. Otherwise wealth tax may not arise at all. Further details are set out in the Wealth Tax Commission foreign countries background papers.[72] It is hard to discern any set of principles that could be useful for UK taxation of trusts

The OECD Report in 2018 (ch.4, p.90) rather ignores the practical problems and legal reality of trusts noting simply:

> *Treating trusts as see through entities seems appropriate. Following the approaches adopted in France and Spain, trusts can be treated as transparent or "see through" in the sense that the trustee is legally obligated to identify the settlor or beneficiary to tax authorities with the value of assets held in the trusts and then allocate these assets to the settlor or to the beneficiaries on a proportional basis to their assessable wealth.*

The current UK tax system

As Appendix A shows, UK resident trusts set up by a UK domiciled settlor where the settlor is excluded are taxed as a separate person in their own right for IHT, income tax and CGT purposes. However, if income of a discretionary trust is distributed, the beneficiary can reclaim the 45% income tax paid by the UK resident trustees if they pay tax at a lower rate. Income of a life interest trust is taxed at 20% on the trustees with the life tenant then paying a higher rate or reclaiming the basic rate. If the trust can benefit the settlor or spouse/civil partner, then irrespective of who actually receives the income, the settlor is subject to tax on the income with

[71] Switzerland does not tax the net assets of a foundation to wealth tax at all although in some cases depending on where the founder or contributor was resident at date of funding there may be tax going into the foundation. See also Perret (2020, p.14).
[72] See bibliography for details: Banoun (Norway); Dupas (France); Eckert (Switzerland); Paoletto et al. (Italy); Ramallo (Spain); Rehr (Germany); Ta and Vanvari (India); Tirard (France).

a right of reimbursement from the trustees. The position is different for non-resident trusts set up by foreign domiciled or non-resident or deceased settlors.

The CGT position of a UK resident trust is not affected by whether the settlor can benefit. In the case of non-UK resident trusts, the UK domiciled or UK resident settlor is personally liable to CGT on the gains realised by the trust if *any of* the settlor, children and grandchildren or their respective spouses can benefit. [73] For foreign domiciled or non-resident settlors, the trust CGT position is different.

For IHT purposes, the trustees will generally pay IHT but only if the settlor was UK domiciled when the assets were settled. If the settlor can benefit, there is additional IHT on the settlor's death. Unlike income tax and CGT, the domicile position of the settlor is tested only at the date the trust assets are settled for IHT purposes not year by year.

Wealth tax must try to navigate a way through this complexity bearing in mind it is an annual tax like income tax or CGT but nevertheless a tax on capital like IHT.

Possible wealth tax scenarios – allocating the wealth of the trust to the settlor, beneficiaries or trustees

The 1974 Green Paper (ch.2, para.23) summed up the problems as follows. In relation to foreign domiciled settlors it noted rather puzzlingly:

> *...even if there are one or more beneficiaries or discretionary objects resident in this country there are no grounds on which it would be right to bring the trustees or the whole of the trust assets within the charge to the tax.*

Although it then went on to suggest that a UK resident individual could be assessed on 'the actuarial value of any fixed interest'. In the debate below, the Green Paper seems to be considering only UK resident trusts or ones where the settlor was domiciled or ordinarily resident in the UK *at the time the funds were provided*, a limitation which seems rather odd in the context of an annual wealth tax although is more relevant for IHT. It would mean a settlor could set up a trust when non-UK resident or foreign domiciled, return to the UK and the assets would escape wealth tax permanently. This is the position for IHT but is not desirable for an annual tax. At paragraph 18 onwards it notes:

> *For straightforward trusts with one or more life tenants and remaindermen a possible approach might be to attribute the trust capital to the various beneficiaries of the trust according to the actuarial values of their respective interests in it; and then to tax the various amounts of capital at the rate they would bear if they formed the top slices of the beneficiaries' own wealth. However there would be two difficulties in this: first the values of the interests of the various beneficiaries in a trust generally add up to less than 100 per cent of the value of the trust funds and rules would have to be made for attributing the balance; second it may not be possible, even with a non-discretionary trust, to identify all the reversionary interests (which may, for example, include children yet unborn). The best practical solution may therefore be to ignore the reversionary interests and to attribute the whole of the value of the trust funds to the life tenant: the trustees would then be relieved from the full charge to tax insofar as that charge exceeded the liability which would have been due if the trust assets (together with the assets of any other trust of which he was life tenant) formed the top slice of the life*

[73] S.86 TCGA 1992 which is probably in breach of EU law in its application.

tenant's wealth. Similarly, where the trustees of a trust are required to accumulate the income for an identified beneficiary contingent on his reaching a stated age with power to make payments to him at their discretion, the assets could be attributed to the beneficiary so that the rate would be found, if he was a minor, by aggregating them with his parents' wealth.

Discretionary trusts. The approach to straightforward trusts cannot apply to the wholly discretionary trust in which the trustees have unfettered discretion as to the application of income and capital between what may be a very large number of discretionary objects. In such a case there are no beneficiaries by reference to whose circumstances the charge at the top rate of tax might be abated. The Government considers that while the settlor remains alive the charge should be calculated primarily by reference to his circumstances, as if the trust and any other discretionary trust he had set up had never been made. This will usually be close to the realities of the situation in which the trustees may be expected to follow the settlor's wishes. It may however be possible to give a measure of relief by reference to the payments of income actually made to the discretionary objects of a trust, although it would be necessary to assume for this purpose that the capital used to produce the distributed income was no more than what was required to produce the income from investments yielding a reasonable rate of return. Indeed if the settlor were dead such a method might provide the only basis whereby relief could be given as the years passed: it would however need to be carefully drawn bearing in mind the possibilities of abuse.

Intermediate trusts. There are many types of trust falling between the extremes of the straightforward trust with indefeasible life interests in possession and reversionary interests on the one hand and the out and out discretionary trust on the other. These will require consideration according to their circumstances on the general lines set out above. The rules for trusts will apply to other arrangements having similar effect.

In short, the above left the position rather vague with many practical questions unanswered. Wheatcroft (p.415) similarly noted the difficulties of taxing trusts in anything less than an arbitrary way. For example, the difference between fixed interest and discretionary trusts may be overstated as Appendix A illustrates. Many fixed interests are revocable with a limited actuarial value and many discretionary trusts do provide regular benefits to beneficiaries.

Possible methods of dealing with wealth tax in relation to trusts are:

(a) To allocate the capital of the trust fund to the settlor in cases where he can benefit or the trust is revocable. This is similar to the position adopted for IHT and income tax.[74] The trustees would be liable to fund the wealth tax but the rate and whether wealth tax is payable would be determined by the wealth tax position of the settlor. Secondary liability could be imposed on the settlor.[75]

(b) To treat the life tenant of the trust as entitled to the underlying trust capital – as with Estate Duty and IHT in relation to pre-2006 interest in possession trusts, disabled trusts and many will trusts. So 'to X for life or until earlier revocation by the trustees and then to Y absolutely' would mean not that X is taxed on the value of his life interest based on his mortality or on the risk of the life interest being revoked; instead tax would be charged on the whole value of the trust fund with his exempt wealth tax threshold shared between his personal wealth

[74] FA 1986, s.102.
[75] Cf. IHTA 1984, s.201 and 204.

and the trust wealth – albeit liability for wealth tax on the trust fund would be taken from the trust assets.

The tax itself would need to be funded out of the trust fund as X in practice may have little other wealth and his life interest in the real world may yield him few positive benefits. It may be revocable by the trustees without his consent and therefore of little practical value to him. This is broadly how IHT has worked in traditional life interest settlements with the trustees being primarily liable to pay the tax and the unused nil rate band of the life tenant is prorated between trust and free estate on death. The life tenant would be treated as entitled to the underlying capital but not for all wealth tax purposes. Thus for example, personal debts incurred by the life tenant cannot currently be deducted against the value of the trust fund for IHT purposes and should not be deductible against the trust fund for wealth tax purposes.

(c) To tax all irrevocable discretionary trusts where the settlor cannot benefit or is dead, at the highest possible wealth tax rate ('the trust rate') with a limited exempt threshold. The trust could not have the same exempt threshold as an individual: if it did, substantial tax advantages would then be obtained by a settlor simply giving away wealth to a lot of trusts for his children and excluding himself from benefit. CGT deals with this by simply halving the annual exemption of the individual and then dividing it between the number of trusts set up by the settlor (irrespective of whether the settlor can benefit). IHT gives the nil rate band to the first trust settled and then all other trusts are subject to tax at a higher rate. Given wealth tax is an annual tax, the CGT solution seems best adapted for wealth tax. The trustees would be liable to pay the wealth tax out of the trust fund. This is less arbitrary than taxing the settlor personally on trust wealth simply because he funded the trust even if he is excluded, but it ensures there are no advantages from giving away wealth to lots of trusts rather than outright; the trust pays at the highest rate with a very limited exempt threshold.

(d) Where tax is levied on discretionary trusts as in (c) above there would be a right to adjust the rate according to the wealth of the beneficiary when the capital is distributed to a chargeable person. This is a little like the current income tax regime of non-settlor interested discretionary trusts. The trustees pay at the highest marginal rate (45%) but as and when the income is distributed to a beneficiary the beneficiary may be able to reclaim some of that tax if taxed at lower rates. This would in effect incentivise outright distributions to poorer beneficiaries.

Which trusts should be taxed?

Once the above principles have been determined it should then be possible to consider which trusts will be subject to a UK wealth tax. Where the trust fund is situated abroad, and none of the trustees, settlor and beneficiaries have ever been UK resident it is difficult to see any basis on which the trust fund could be taxed. What then are the connecting factors that make the trust fund liable to wealth tax following the above principles?

There are three possible connectors for trusts: **the settlor or donor** – the person who settles or gives the assets into trust; **the trustees –** who hold the asset in trust, managing the Trust Fund (i.e. the assets of the trust) for the benefit of others; **the beneficiaries –** who may or may not include the settlor but usually include the settlor's family.[76] These are the people for whom the trust assets are held and who are intended to benefit. In some cases they may not yet be born. One difficulty is that the same individual may perform a multiplicity of roles. It is, for example,

[76] In the case of non-charitable purpose trusts (not generally recognised in the UK) and charitable trusts the beneficiaries are not individuals. See Appendix A.

possible for the settlor to be one of the trustees and it may be that he is also a beneficiary (despite very significant tax disadvantages). A beneficiary who is not the settlor may also be one of the trustees. Example 7 illustrates the simple example where the settlor can benefit.

Example 7

Sid transfers shares into the names of himself and his son to be held on trust for Sid for life with remainder to his son and daughter in equal shares. Sid is settlor, trustee and life tenant (interest in possession beneficiary – see Appendix A). His son is a trustee and also a beneficiary entitled ‘in remainder’ on the death of Sid. His daughter is a beneficiary entitled in remainder but is not a trustee. How should the trust be taxed?

In these circumstances where the settlor is UK resident and can benefit it is relatively easy to see that (a) should apply – wealth tax is due cumulated with Sid’s total wealth and the liability attributable to the trust fund paid out of that fund. This is very much how the pre-2006 IHT model worked where the settlor was life tenant. The rates and nil rate band were calculated based on total personal and trust wealth and then the liability to pay the tax prorated between the two, with the settlor remaining secondarily liable for the trust IHT where the trust was non-UK resident.

The residence of the trustees can surely be discounted as a relevant connecting factor, as unlike individuals, trust residence is easy to manipulate simply by appointing professional trustees who are resident in a jurisdiction such as Jersey. This follows the IHT position where trustee residence is not relevant. So we are left looking at the residence of the settlor or of beneficiaries as possible connecting factors in determining whether the trust assets are liable to wealth tax.

It is important to realise that the persons to whom the wealth may be allocated for the purposes of determining rates (e.g. the life tenant or the trustees) do not have to be the same persons as those used to determine whether the trust fund is liable for wealth tax in the first place. Nor does the wealth tax on the trust fund itself have to be paid by the settlor or beneficiary: once liability has arisen because of a beneficiary or settlor being UK resident, the tax itself could be funded out of the trust fund. This is very similar to how IHT works in relation to life interest trusts.

Example 8

(a) Sid is UK resident and settles assets on irrevocable discretionary trusts for his grandchildren who all live abroad. Sid is excluded and is not a trustee. The trust assets are all situated abroad apart from one house in the UK which is let. The trustees are not UK resident. Every year the trustees distribute 1% of the trust fund to the grandchildren.

(b) Sid is UK resident and settles assets on irrevocable trust for his daughter Penelope for life and then for her children on her death as the trustees decide in their absolute discretion. Penelope and the children are all non-UK resident and the trust assets are non-UK situate. Sid is excluded and cannot be a trustee.

It should be relatively easy to accept that where the trust holds UK situated real estate or enveloped real estate, *whatever other connecting factors are in play*, the trust should be liable to pay wealth tax on that UK real estate just like any non-resident individual (see Section 4). The tax on the UK house in Example 8 (a) could be paid by the trustees out of the trust fund.

How should other assets held by the trustees be taxed in Example 8? Sid cannot benefit, so he is not taxed personally but his residence status should still be *relevant* to determining whether the trust is taxed (see above). Allocating the wealth of the trust fund to the trustees (as per method (c) above) and then allowing the non-resident discretionary beneficiaries in Example 8(a) to reclaim some of that wealth tax if capital is distributed to them is reasonable. Given trustees, assets and beneficiaries are all non-UK resident, the only basis on which wealth tax would be charged in Example 8 is that Sid the settlor was UK resident when he funded the trust. Although he is not liable to pay, he is the relevant connecting factor that imposes continuing liability on the trustees.

Once Sid dies or becomes non-UK resident, should the connecting factor to the UK end (as with CGT and income tax) or (as occurs in IHT) should it be the status of the settlor at the date *he funded the trust* which remains relevant forever? In the author's view the latter is correct. If Sid had given his property to the grandchildren or Penelope outright there would have been no wealth tax payable by them in future on the non-UK property. By choosing to use a trust, in effect he has subjected the trust fund to continuing wealth tax. If the trustees want to avoid ongoing wealth tax they can simply distribute the trust fund outright to the non-resident beneficiaries. In other words they can 'complete' as it were, the gift that Sid started many years ago.

So on that basis the trustees pay wealth tax in Example 8(a) at the standard trust rate on the trust fund per (c) above and in Example 8(b) the trustees pay wealth tax by reference to the total wealth of Penelope the life tenant as per method (b) above. Presumably as a non-resident life tenant, Penelope's personal (non-UK) wealth would be excluded in considering the rate of wealth tax imposed on the trust assets. The same position will continue for Penelope's life interest even after Sid's death.

What if Sid had been non-UK resident when he funded the trust but the discretionary beneficiaries in Example 8(a) are all UK resident? It is true that once capital is distributed beneficiaries will pay wealth tax on capital distributions if resident here as it will form part of their wealth tax estate going forward, but it would seem strange to allow UK resident beneficiaries to enjoy the benefits of trust wealth (e.g. art on their walls or occupation of trust houses) without some wealth tax being paid. Equally, simply imposing wealth tax on the beneficiary by reference to the whole capital value of the trust fund may be unfair where beneficiaries receive no or minimal benefits.

Similarly what happens if Sid was non-UK resident at the date he funded the trust in Example 8(b) above but Penelope becomes UK resident? If the life tenant is UK resident then it seems logical to tax the trust fund by reference to the position of Penelope irrespective of Sid's position. In a sense it is a logical result of Sid having chosen not to complete the gift although it might be objected that HMRC are having it both ways: if Sid is UK resident and gives to the trust without completing the gift the trust is chargeable: if he gave outright to non-resident beneficiaries they would not be.

If Sid is non-UK resident and does not complete the gift but gives to a trust with a UK resident beneficiary it is again chargeable because if Sid had given direct to Penelope and she was UK resident she would be chargeable.

Even if Penelope's life interest is revocable it is not unreasonable to subject the trust fund to wealth tax in the year when she is UK resident. It is, after all, an annual tax not a 40% inheritance tax.

It is assumed that charitable trusts and charitable companies and associations would be exempt from annual wealth tax (as they are for IHT). They have no shareholders or ascertainable individual beneficiaries. The settlor has by necessity given up outright ownership to another entity whose purpose is charitable and supervised by the Charity Commission. This is quite separate from the question of whether the settlor should receive a tax deduction for making a gift to the charity in the first place. Other trusts such as employee benefit trusts could be adapted within the design below if felt desirable.

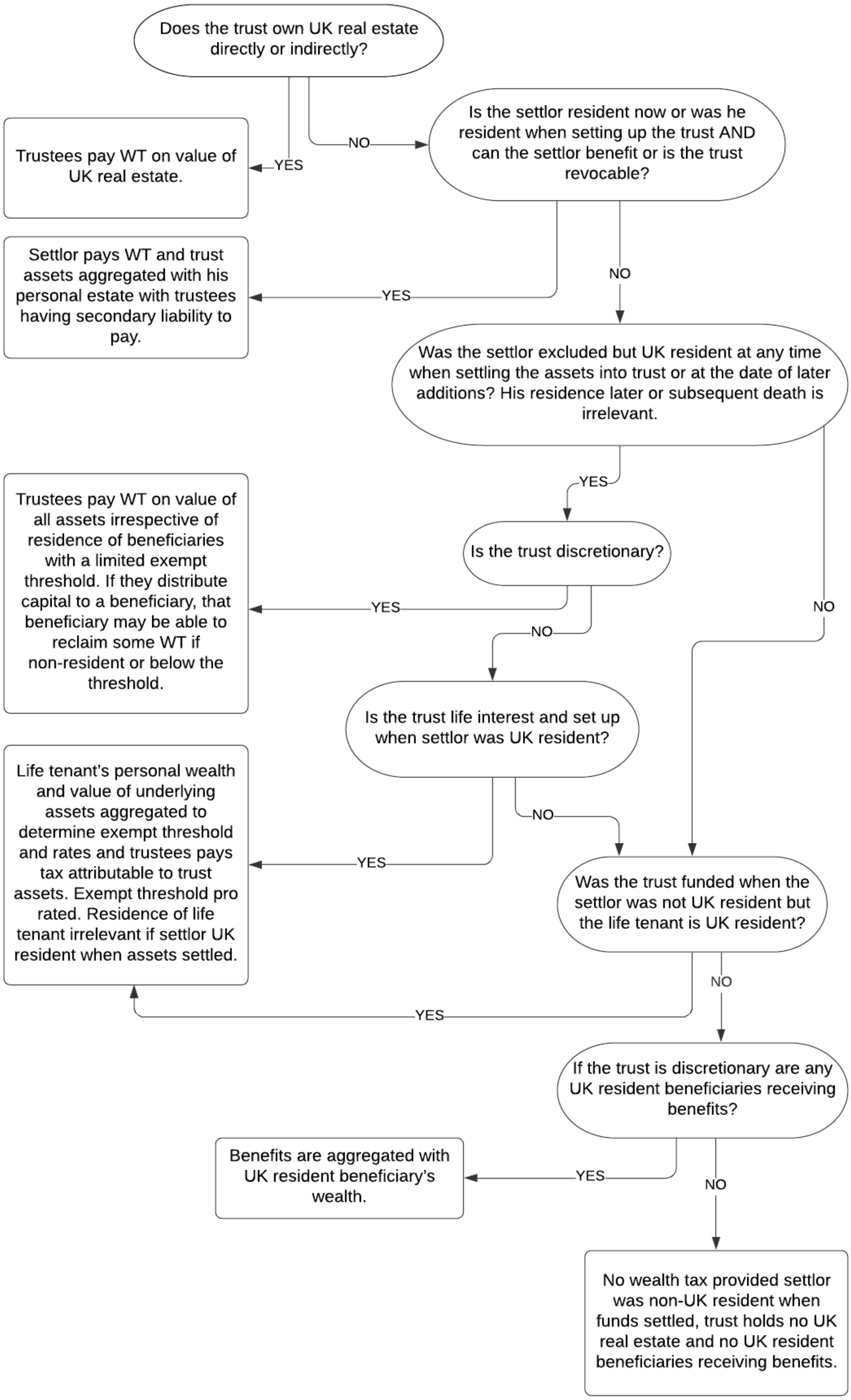
Summary of a possible design for trusts

Below may be a possible solution which strikes a reasonable balance between arbitrariness and avoidance, acknowledging that the settlor or beneficiary does not own the asset outright but nevertheless accepting that benefits conferred by trusts need to be taxed and that the settlor has a choice on whether to make an outright gift to someone or settle it in trust:

(a) Trustee residence is irrelevant to liability. Domicile of settlor and beneficiaries is irrelevant.
(b) Where the trust holds any UK real estate it is subject to wealth tax and the tax is paid out of the trust fund. This is irrespective of the residence of anyone.
(c) Where the settlor was UK resident when he funded the trust or he subsequently becomes UK resident and in either case he can benefit from the trust or it is revocable, the settlor is liable to wealth tax on the trust assets (aggregated to his personally owned assets).
(d) Where the settlor is excluded but was UK resident when he funded the trust, the total trust fund is subject to wealth tax permanently (irrespective of whether the settlor dies) at the highest wealth tax rate with a limited threshold exemption (to discourage settlors setting up multiple trusts) if discretionary and irrespective of the residence of the beneficiaries. If the trust makes capital distributions to UK resident beneficiaries then such capital can be included in the beneficiary's wealth tax base and a repayment may be possible if the beneficiary has little further wealth. If the trustees make capital distributions to non-UK resident beneficiaries then they can reclaim wealth tax paid in that year.
(e) Even if the settlor is not UK resident when he funded the trust but the trust confers benefits on UK discretionary beneficiaries e.g. use of houses etc, then a proportion of the trust fund is subject to wealth tax. This is irrespective of whether the settlor can or cannot benefit.
(f) If the trust is interest in possession and excludes the settlor but either the settlor was UK resident when he funded the trust OR the life tenant is UK resident at any time, the whole trust fund is subject to annual wealth tax based on the personal circumstances of the life tenant. If the life tenant is non-UK resident with no UK assets only the trust assets would be taken into account in calculating the rate of wealth tax and the exempt threshold of the life tenant is allocated entirely for the benefit of the trust.
(g) Liability for paying wealth tax rests primarily with the trustees. In the case of a non-resident trust, secondary liability could fall on the settlor as with IHT.

The above attempts to navigate between the connecting factors of the various parties but there are no doubt other options! It has a certain level of complexity but tries to reflect the reality of trust benefits and the decisions of the settlor. The settlor is not penalised personally for setting up a trust from which he is excluded but on the other hand the decision to make a gift into trust rather than outright is reflected in a greater complexity of taxation. It is a more subtle method than just taxing by reference *only* to the residence status of the settlor or of the beneficiaries. The question is important because if the price for introducing wealth tax was the abolition of IHT, without an effective wealth tax the tax yield on trusts could be seriously eroded.

A flow diagram could perhaps run thus:



Estates

On a UK resident individual's death, the personal representatives (the people who administer the deceased's estate) should presumably pay wealth tax while the estate is in the course of administration. Otherwise there is an incentive to delay finalising the administration of the estate. On assent of the assets to a beneficiary, that beneficiary will thereafter pay wealth tax on the value of the assets received.

If IHT is retained one question is whether there should be a 12 month period after death in which wealth tax is not paid, given the personal representatives of the deceased have to fund IHT. What rates and thresholds should operate for the personal representatives? If IHT is also payable should wealth tax be deductible against IHT in first year? If the deceased was non-UK resident but owned UK real estate or enveloped real estate then the estate would similarly be liable to wealth tax as well as IHT on those assets.

6. On what assets is wealth tax charged?

Key design features relate not only to people but to assets. The OECD report in 2018 recommended a broad tax base with few exemptions to avoid creating distortions in savings decisions as well as incentives and opportunities for avoidance. The starting point is therefore to include in principle all assets of an individual in the tax base (a) on grounds of horizontal equity and (b) on the basis that any exemption or relief creates an opportunity for avoidance, unfairness and ultimately resentment from those who have to pay. In countries that have abolished wealth tax, such as Ireland, Germany and France, the varying tax burdens imposed on different assets was a major constitutional problem and a significant factor in prompting abolition.[77] See Rehr (2020) Germany; Tirard (2020) France. Advani and Tarrant (2020) point to the difficulties in exempting assets.

However, most countries with a wealth tax have been singularly unsuccessful in following the OECD model of a broad base with few exemptions. As noted in the foreign country papers, almost all give a discount for the main residence (and Ireland and India gave a complete exemption). Most countries exclude from the wealth tax base 'normal household and personal assets for domestic use' such as furniture, carpets etc. There are a variety of other exemptions or discounts often given for agricultural land (India and Ireland), works of art (France), pension rights and human capital (all countries), shares of active trading companies (France and Spain).

Four problems typically arise if a fully comprehensive wealth tax is to be introduced. First, the administrative burden and compliance costs are likely to be higher. Although pragmatic solutions can be adopted (in terms of banded values, valuations every 5 or 10 years instead of annually, formulaic approaches for certain assets such as family companies) any administratively convenient solution is likely to move away from an open market value and therefore distort the tax base.[78]

Secondly, managing levels of uncertainty on valuation is tricky. Valuing a house is a very different and much more certain proposition than valuing a minority shareholding in a private company. Some solution needs to be adopted for dealing with minority shareholdings that avoids obtaining multiple different values but is near enough to market value to be justifiable. Even so, there are clear difficulties about valuing assets such as farms and private businesses.[79]

Thirdly, some types of property are seen as just too contingent or uncertain and are generally excluded from the wealth tax base, i.e. human capital and pension rights. Whether this is correct is discussed further below.

Fourthly, assets commonly excluded from the tax base or given discounts such as family companies, houses, farms or pension rights are often exempted or discounted not for reasons of principle but because they raise practical or political issues. In short, exemptions have often been used to treat the 'symptoms' of wealth tax design deficiencies elsewhere.

This section considers particularly problematic assets and whether the reasons for exempting them are reasons of principle or more practical issues of design.

[77] See Sandford and Morrisey (1985).
[78] See Troup, Barnett and Bullock (2020)
[79] Daly and Loutzenhiser (2020) and Clark and Fu (2020).

Human capital

Should human capital as a matter of principle be included in the tax base, i.e. the capitalised value of future earning power? The argument cited for including it, is that the skills of a person generate future income and the capitalised value of their earning power is a form of personal wealth. A person who invests their liquid capital in a top-level management course instead of buying an asset such as shares is investing to expand his skills so that he can command a higher earned income in the future. Should the capitalised value of future earnings power therefore count? No country has seriously contemplated including human capital in its wealth tax base. Unlike a house or shares or pension rights, human capital is not a property right with any of the rights normally associated with the legal concept of ownership, it is not transferable, and is not wealth in the accepted sense. As a matter of principle it should not be included.

Pensions

The other asset excluded from all countries' wealth tax base is pensions. The exclusion of pension rights from wealth taxes appears to be based on a combination of conceptual, political and administrative reasons. Reasons cited are a mixture of principle and practicality: 'taxing pensions discourages people to save for their retirement', 'the government gives me an incentive to save so why should you tax me', 'pensions are not realisable or saleable assets and the person paying the tax may never live to take the pension and they may not have the cash to pay the wealth tax' or 'they have limited transferability'. The UK Green Paper proposed a wealth tax exemption for approved pension schemes for all these reasons.

The OECD 2018 report noted that:

> *...exemptions for pension assets are justified on social grounds, because of the social benefits that come from retirement income, but also because it is difficult to justify both socially and politically taxing individuals on wealth that is not within their present control and from which they cannot withdraw funds to pay the tax. However, this creates inequities between different taxpayers, raises fairness concerns and creates tax planning opportunities.*

This seems to suggest that there are principled reasons for exempting pensions even if it creates distortions.

Pension rights in the UK[80]

As noted in Ramm and Eames (2020), UK pension schemes take one of two main forms. In defined contribution (DC) schemes, contributions are fixed while the benefits are determined by the accumulated contributions paid in during the working life plus the actual return earned on investment. At age 55, the pension holder has considerable flexibility as to how and when funds are withdrawn, which can include taking a 25% tax-free lump sum. Further withdrawals are taxed at the individual's marginal income tax rate. Alternatively, the fund can be used to purchase an annuity. On death, the DC income/assets can be transferred to a beneficiary.[81] In general, DC schemes are similar in structure to other forms of savings and portfolio investment, but with a tax-relief wrapper.

[80] The author is grateful to Loutzenhiser and Mann (2020) for material on this and later sections.
[81] Small businesses and sole traders can hold the investments of their pension scheme under either a Small Self-Administered Scheme (SSAS) or a Self-Invested Personal Pension (SIPP).

Under defined benefit (DB) schemes, benefits do not directly relate to the accumulated contributions but are usually contingent on other factors such as the length of contribution and/or a type of average or annual salary before retirement. DB schemes are common in the public sector. If the pension holder dies before reaching pensionable age, he or she is typically entitled to a death in service payment calculated as a multiple of earnings; this is similar to a benefit under a (very expensive) life insurance policy. By way of example, in the Universities Superannuation Scheme (USS) the death in service payment is 3 times annual salary.[82] Pension age varies but typically, including for USS, the normal pension age is 65. At retirement age, and in some cases sooner, the pension holder generally has the ability to take some amount out as a tax-free lump sum and then begins to receive his or her pension benefits as calculated under the plan formula as a periodic payment until death. On the death the pension holder a portion of the pension (e.g. one-half) is paid to a surviving spouse or other dependent.

Should pension rights be subject to wealth tax?

It is acknowledged that there are a number of practical problems in taxing pensions. These relate principally to liquidity rather than valuation (as even DB schemes are valued on divorce and there is clearly a methodology that could be further refined and agreed). Even in relation to liquidity the practical problems do not seem insuperable provided the tax can be withheld from the pension fund (see Loutzenhiser and Mann, 2020). The problem may therefore be one of administration and political economy: if pensions are included in the wealth tax base, many more people are likely to have to pay the wealth tax and so many more people will object to the tax on principle. There will be more work for HMRC.

These are issues of practicality not principle and there are serious problems of principle in exempting pensions. Some of the objections of principle mentioned above are in fact not very principled. It is true that the Government encourages people to save for their retirement by the use of incentives such as pension tax relief but this is true of other savings vehicles such as ISAs and yet it is not suggested that these should be exempted from the wealth tax base. People are given tax relief (investors' relief, the Seed Enterprise Investment Scheme, the Enterprise Investment Scheme etc.) to invest in small risky enterprises. Does a tax incentive in one area mean a valuable asset (helped by the earlier tax incentive) should never be subject to wealth tax?

To the objection that pension rights are only valuable when you retire it could be said that whether the person survives to take the pension is not materially different from the question of whether a person survives to stop work and live off their savings in retirement. Pension benefits are in fact transferable to a surviving spouse or dependant and moreover currently transferable on death largely free of IHT. The distortions within the current system bizarrely favour wealthy people *not* taking their pension in order to pass it onto their dependants IHT free, instead depleting their other assets.

To omit pension rights from the tax base would be to omit a very valuable possession and an increasing part of the nation's wealth.[83] In constant 2017 prices, private pension wealth increased from £3.39 billion in 1974 (14% of total wealth excluding state pension) to £14,627 billion in 2017 (42% of total wealth excluding state pension). A person with valuable pension rights not only enjoys an element of financial security that is comparable to someone with capital assets but in fact, as Ramm and Eames show, just like other assets pensions can be valued and divided (and frequently are on divorce). Omitting future pension rights from the wealth tax base seems contrary to horizontal equity – i.e. that people in broadly equal circumstances should pay equal amounts of tax – and is likely to encourage avoidance behaviour. A senior civil servant

[82] see https://www.uss.co.uk/
[83] See Advani, Bangham and Leslie (2020).

with an inflation proof pension may pay far less wealth tax over his lifetime than the small businessman who puts all his savings into his business with the intention of selling up on retirement and buying quoted stock and bonds to produce an income. Why should the businessman pay wealth tax on all his business assets throughout his working life plus on his income producing investments after retirement yet the civil servant will pay no wealth tax on the value of his pension rights? Finally, to omit pensions from the tax base would seriously undermine the revenue yield from wealth tax and likely require a higher rate on the remaining assets.

Family companies and unincorporated businesses

The question of whether to exempt private companies and incorporated businesses is in a sense similar to that of pensions. Exemptions are often offered for reasons both of design and principle. In fact there is much more variation here between countries on how to tax private businesses. Switzerland essentially operates a formulaic approach applied by the Swiss tax authorities to businesses on the basis of their statutory accounts with a limited right of appeal. Norway operates a different method based round the audited book values, and Spain varies its valuation techniques depending on whether the business is audited or not but with an exemption for some active businesses. Ireland operated very significant exemptions and discounts for productive business assets and shares in trading companies. India and France operated an exemption for active trading businesses.

The latter approach suggests that some governments believe there are principled reasons for exempting 'good' trading businesses and taxing 'bad' investment businesses. The same policy is adopted in the UK for IHT: businesses with a 49% investment element but are 51% trading are wholly exempt from IHT; a business that is 51% investment and 49% trading is chargeable to IHT. Why is one regarded as better in principle than another as there can be no practical reasons in terms of liquidity or valuation for the difference? The policy of business relief for inheritance tax (BPR) has never been clearly articulated as a question of principle but if trading businesses are to be exempted from wealth tax some principles would need to be set out which are more than just technical solutions to liquidity and valuation problems.

As a matter of principle:

(a) Do we want to encourage start-ups and therefore exempt these for a minimum period? If we did, there would need to be some evidence about the effectiveness and value for money of these sorts of initiatives and the position would need to be closely monitored. In February 2020 the National Audit Office pointed out the lack of monitoring round many tax reliefs.

(b) Is there a lifestyle business such as a farm where as a matter of principle we do not want to tax the full value or is it really a liquidity problem because the farm has little profit (see Clark and Fu, 2020)?

(c) Are trading businesses necessarily to be encouraged more than other businesses and if so what sort of trading businesses? The tax system in the past has provided reliefs (e.g. the Business Expansion Scheme) for investment in hotels, property development, but EIS is much more limited as governments have decided that only a small group of trading businesses should be given reliefs. Which ones? And why?

(d) Is it only private unquoted trading businesses that should be given relief not AIM shares and if so why? Is this to encourage entrepreneurship and investment in productive assets?

These questions of principle need to be addressed before considering exemption as a design solution to practical issues. The OECD cautions that 'exempting or providing significant relief for business assets creates tax avoidance opportunities, particularly at the very top of the wealth distribution, encouraging taxpayers to shelter their assets within their business' (OECD, 2018, pp.85 and 91). The 1974 Green Paper (ch.3, para.35) recommended against exempting business assets from the tax base for similar reasons:

> *...the wealth tax would lose much of its desired social effect if a substantial proportion of those who are among the wealthiest in the country were not brought within its scope.*

Nevertheless, it is clearly hard to resist wealth tax exemptions or some form of tax preferences for businesses. Typical practical problems include:

(a) Start-ups which may be potentially profitable but are loss making in early years. Where the shareholder is independently wealthy this matters less as he has other resources to fund the wealth tax but it has been regarded as a problem in Switzerland and Norway. Do Norway and Switzerland have fewer successful start-ups compared with say the UK, Sweden and Germany and if so, is this because wealth tax is a deterrent on this sort of productive economic activity? Or is it for completely different reasons? Little work seems to have been done on this. Evidence is anecdotal.

(b) Companies which go through a bad patch but may recover profitability. E.g. changing market conditions, COVID-19 etc. The wealth tax has to be funded throughout this period, making adjustment to new commercial conditions problematic as valuations tend to be done in arrears.

(c) Liquidity issues. These are discussed in Loutzenhiser and Mann (2020). They are particularly relevant to private companies where wealth is over £5 million.

(d) Valuation issues. See Daly and Loutzenhiser (2020). Does each shareholder produce a separate valuation or should the valuation be done by HMRC and given to the company which then provides it to the shareholders? Or should it be done by the company and given to the taxpayers to add the figure to their net wealth? The separate background papers on valuation of different types of businesses illustrate the significant difficulties and delays that can arise on valuation in the CGT and IHT contexts. Equally, giving a relief or exemption itself sets a new boundary and gives rise to different disputes. So a relief may solve one problem only to create another. See for example the extensive disputes seen in cases on APR cited in the Clark and Fu (2020).

(e) Discounts. A valuation of the whole company may not properly reflect the value of the individual shareholder's shares. For example, on an open market basis valuing the shares of five shareholders with 20% each will not add up to 100% of the company's value. There will be a significant discount for each minority shareholding. The UK Green Paper proposed aggregating the holdings of all connected persons for valuation purposes only i.e. spouses, siblings, ancestors or lineal descendants or trustees of a trust set up by them or in which any of them had a right to the income or 'interest in possession' (see Nelder, 2020).

Example 9

Peter and Jain are married and have three adult children. Peter owns 100% of his profitable private trading company. Peter gives 10% to each of his three children and 22% to his wife leaving him with 48%. For IHT valuation purposes, Peter and Jain are each treated as owning a controlling shareholding and Peter's shares are valued as if he held 48% of a 60% holding accordingly.

Example 10

Peter gives 10% to his children and 11% each to two trusts for the benefit of his adult children and Jain. His remaining 48% is now valued as a minority shareholding. The two trusts are not cumulated together for valuation purposes. Each child's 10% is valued with a significant discount. The overall value of the company that is subject to wealth tax will be significantly less than the value of the whole.

It might be argued that Example 10 is not an unsatisfactory result. In the real world the children do not have much control over the company and this is duly reflected in the value of their shares. It may also be argued that the adult child has a low base cost on the private company shares. If the company is then sold, the additional tax is picked up in the form of CGT. In short, wealth and CGT can complement each other.

However, it does encourage certain types of avoidance including use of multiple trusts and complicated share provisions, particularly on family investment companies.[84] Even if the trusts are all taxed at the highest rate with no threshold, the value of what each trust is taxed on would be significantly reduced. One option would be to extend the related property provisions so that for valuation purposes trusts set up by the settlor are valued as one.[85] The Green Paper suggested aggregating the shares of all connected persons for valuation purposes. That would deal with the problem illustrated above in Example 10. It would particularly affect family investment companies. However, it would mean that an adult child might be subject to wealth tax on an artificially high value which would increase liquidity problems.

Little has been said in other papers about unincorporated businesses, but clearly partnerships in particular are an important part of a country's wealth and would need to be valued. The value of unincorporated businesses (whether sole trader or partnership) would in principle need to be included as chargeable subject only to the same issues of principle (if they can be formulated) as apply to companies. In the case of sole traders there will usually be little value as the goodwill is entirely bound up with the individual. However, partnerships such as law firms etc. may have significant intrinsic value represented by property, work in progress and goodwill and this will have to be valued and allocated to the individual partner. In the case of unbilled work in progress (WIP) it would presumably be valued net of income tax payable. Difficulties on valuation may arise if the partnership agreement (as is common) provides that the partners on retirement are entitled only to the return of their capital with no value given for goodwill. The wealth tax valuation will presumably need to reflect this practical reality.

Agricultural property[86]

Commentators including Sandford, Willis and Ironside (1975), the Meade Committee (2011) and the 1974 Green Paper generally recommend against exempting agricultural property from the tax base or offering especially favourable terms. However, Sandford et al. recommended a

[84] Often seen as an alternative to trusts post 2006 where capital is gifted to a UK company initially owned by the donor who then carves up the shares creating different classes with different rights. He gives away the shares that carry the capital growth and retains the shares which may only give him voting rights. That way he keeps control but the capital value is with the next generation (but without their control).
[85] And to some extent this reflects the IHT treatment when property is moved from one trust to another – for certain limited IHT purposes the transferred property is treated as remaining in the first settlement. See s.81 IHTA 1984.
[86] Again I am grateful to Loutzenhiser and Mann for input here.

‘cautious’ valuation of agricultural property under a wealth tax as well as the possibility of a ceiling on the tax (p.229). The Meade Committee was firmly against tax concessions for agricultural property (1978, p.358-9), preferring measures that would make it easier for owners to raise outside capital to pay the tax (see Loutzenhiser and Mann, 2020 for more on this).

The Meade Committee argued such tax privileges help those who need no help, reduce the tax base leading to higher tax rates, relieve a special class of wealthy persons from taxing – thus undermining progressivity – and attract funds simply for tax avoidance (p.359). Further, the Committee contended that the excessively high cost of agricultural land and exceptionally low rate of yield on it were in part due to its special tax privileges, which in turn makes it difficult for newcomers to enter the agricultural industry (p.359). Despite these conceptual arguments against tax concessions for agricultural property, the OECD notes that agricultural assets have tended to benefit from preferential tax treatment under European wealth taxes (2018, p.84).

The wealth tax concessions are reflected more generally in capital taxes including UK IHT where a 100% relief can be given on agricultural property. Unless there is something about the nature of a farming family which is felt particularly deserving of protection as a matter of principle, the reasons for relief are generally centred round liquidity. Loutzenhiser and Mann (2020) highlight the particularly severe problems of liquidity for farms and Clark and Fu (2020) highlight the poor profitability compared to capital values.

Residential property

In European wealth taxes, primary residences typically have been eligible for some form of relief in the form of tax allowances or preferential valuation rules. As examples of the former, France offers a 30% tax allowance and Spain offers an allowance up to €300 000 (OECD, 2018, p.83). On the latter, Switzerland taxes primary residences at 60% of its market value and Norway values primary residences at a mere 25% of their estimated market value; it should also be noted that both Switzerland and Norway have relatively low general exemption thresholds (OECD 2018, pp. 83–84). Argentina exempts dwellings where the value does not exceed 18 million peso (approximately £200,000) (IBFD Country Tax Guides, Argentina, para 5.1.2). In Venezuela, taxpayers’ houses, if registered as their principal house before the tax administration, are exempt assets (IBFD Country Tax Guides, Venezuela, para 5.1). In contrast, primary residences were exempt under the Irish wealth tax (Sandford and Morrissey, 1985, p.22). The use of these reliefs is likely driven by political, historical and cultural considerations as well as liquidity concerns rather than issues of valuation although liquidity issues may be relevant.

Rowlingson, Sood and Tu (2020) suggests that people view their primary residence as more than a financial asset, and object as a matter of principle to being taxed on it.

Heritage and art

Artwork and antiques are often exempted from European net wealth taxes on the basis that they are difficult to value and illiquid (practical reasons) and also to help protect national heritage (reasons of principle) (OECD 2018, p.83) The 1974 Green Paper was broadly in favour of taxing such assets but recognised that it could lead to a dispersal of the national heritage and floated the possibilities of deferral of tax or special arrangements conditional on public access. Sandford, Willis and Ironside (1975, p.239) recommended exemption from wealth if combined with appropriate conditions of public access.

The question of principle (preserving our heritage) can be dealt with as it has been for IHT: this provides an exemption relief for heritage property transferred to certain listed bodies (e.g.

National Trust) as well as a conditional exemption requiring certain undertakings be given if the property is retained in private houses. A similar exemption applied under the old estate duty and also for the Irish wealth tax (Sandford and Morrissey, 1985, p.22). In order to qualify for the IHT exemption, heritage property must fall into designated categories including pre-eminent art as well as land and buildings of outstanding scenic, historic or scientific interest: see IHTA 1984 s.31. The undertakings require reasonable public access to be given and proper maintenance if the art or land owned by the private individual is to remain free of IHT.

It should be noted that household goods are almost invariably exempted from wealth tax presumably for reasons of expediency and valuation. The exemption for household goods could be defined to exclude any single item worth up to £5000. This would follow the CGT approach. The value of most household goods is often so *de minimis* it is hardly an issue of practicality or principle to exempt them.

7. Deductibility of debt

Wealth tax is charged on an individual's net wealth so that liabilities and mortgages are typically deductible in order to establish the net amount on which the taxpayer is liable. Debts owed by the taxpayer are generally allowed as deductions in the IHT context provided they have been incurred for consideration or value. So, for example, selling my house worth £1 million to my father for £1.5 million so that he owes a debt of £1.5 million despite the asset being worth £1 million would only be allowable up to £1 million.

Where some assets are exempted, presumably debts incurred to acquire those assets should also be disallowed. This is the approach adopted in the IHT legislation since 2013. Hence loans to acquire farms are generally not deductible against assets that are not exempt from IHT but only from the farm itself (which is free of IHT anyway). The issue of debt therefore becomes more problematic if the tax base is not comprehensive. Taking out a loan does not (as Advani and Tarrant, 2020, say) in itself reduce an individual's tax liability. But if they were then able to invest the loan proceeds into an exempt asset it could do so without anti-avoidance provisions. Similarly they could give away the cash and be left with the debt. Similarly UK residents could give away the cash borrowed and be left with the deductible debt. It is unclear how much avoidance presently occurs in countries with a wealth tax involving debt.

Most countries adopt some restrictions on debt, particularly when taken out by non-residents. For example, in France there is a cap on debt over a certain level on property worth more than €5 million.[87] However, it is possible for non-residents to reduce wealth tax liability on assets situated in say Spain, simply by borrowing to buy the Spanish asset and depositing the cash offshore.

The IHT legislation contains some quite wide anti-avoidance provisions that could be adapted for wealth tax including:

(a) Restricting deductibility of debt when not incurred for full consideration ((s5(5)) IHTA 1984.

(b) Restricting deductibility where the borrower has made gifts to the lender (s.103 FA 1986).

(c) Restricting deductibility of debt where used to buy exempt assets (s.162B IHTA 1984).

(d) Restricting deductibility of debt where the borrowings are taken out by foreign domiciliaries unless the borrowings are used directly for the purchase of UK property and charged on it (Ss.162/162A IHTA 1984).

(e) Restricting deductibility where the debt is never expected to be repaid (see s.175A IHTA 1984).

(f) Imposing IHT on the debt itself if the loan is from an individual or private company wherever resident and is broadly used to buy residential property. (See schedule A1 IHTA 1984).

Some useful lessons can therefore be drawn from the approach adopted in 2013 and 2017 for IHT purposes. It is for consideration whether borrowing taken out to pay wealth tax would itself be deductible if the borrower was UK resident and could show the borrowing was taken out for liquidity reasons.

[87] See Tiraud (2020), France.

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Appendix A: A basic guide to trusts, usufructs, and foundations – The UK taxation of trusts

Emma Chamberlain with Christopher Eames[1]

1. Trusts/Settlements

1.1 Introduction – what is a trust?

Non-lawyers tend to see ownership of an asset in binary form: you either own or do not own the relevant property. However, trusts allow a more subtle type of ownership whereby the person who controls the asset and has legal title (the trustee) is different from the person who may in the future benefit from it or does now receive some benefits (the beneficiary). This 'split' type of ownership is seen in other types of vehicles such as foundations and usufructs but trusts have some unique characteristics discussed below.

In some cases, the person who gives away or 'settles' the asset ('the settlor') may also be the trustee or he may also be the beneficiary or he may be both trustee and beneficiary. In other cases, the settlor may be wholly excluded as a beneficiary and prohibited from being a trustee. Or the settlor may be a trustee and not a beneficiary or vice versa. Some examples of the very different tax effects that can ensue are given later in this paper. It is the very variety of trusts that makes them difficult to categorise and therefore to tax.

A further key characteristic of a trust is that it has no legal personality of its own. This can be contrasted with a company which is a separate legal entity which can be sued and holds property in its own right. A foundation (discussed later) also has legal personality. By contrast, a trust cannot be sued and the trustees hold the assets personally (albeit in their capacity as trustees).

Although somewhat technical, the classic legal definition of a trust is generally taken to be that of Sir Arthur Underhill which he set out as follows:

> *A trust is an equitable obligation, binding a person (called a trustee) to deal with property over which he has control (called trust property), owned and controlled by him as a separate fund distinct from his own private property for the benefit of persons (called beneficiaries….) of whom he may himself be one, and any one of whom may enforce the obligation.* [2]

A similar definition can also be found in the Recognition of Trusts Act 1987, which defines the position thus:

> *For the purposes of this Convention, the term "trust" refers to the legal relationship created—inter vivos or on death—by a person, the **settlor**, when assets have been placed under the control of a **trustee** for the benefit of a **beneficiary** or for a specified purpose.*

[1] The authors caution that this is a very simplified guide to a complex subject. The aim is to provide some basic understanding but it is far from comprehensive and some important aspects cannot be covered here fully.

[2] Underhill and Hayton, *Law of Trusts and Trustees* (19th edition), para. 1.1

A trust has the following characteristics—

*(a) the assets constitute a **separate fund** and are not a part of the trustee's own estate;*

(b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;

*(c) the trustee has the power and the duty**, in respect of which he is accountable,** to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.*

The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust. [3]

[our bold added]

A common thread above is the obligations imposed on the trustee to act in good faith in the operation of the trust (obligations which give rise to a broad range of fiduciary duties) for the benefit of the beneficiaries and to recognise the equitable rights of the beneficiaries. The law of trusts principally focuses on identifying and then protecting those beneficiaries' interests. Some beneficiaries may have an interest only in income and some in capital. Some may have no vested or definite interest in trust property at all and simply benefit, if at all, at the trustees' discretion. However, the beneficiary's right to enforce those obligations and to hold the trustees accountable together with the separation of the trust property from the trustee's personal property are very important characteristics of a trust. The trustee cannot do what he wants with the assets; they cannot pass to his creditors if he goes bankrupt and he cannot deal with them except as set out in the trust deed.

The above definitions show that there are three key parties involved in the legal relationship of a trust: the trustees – the person who holds the assets and administers the trust, ensuring that the terms of the trust deed are complied with; the settlor (the person who gives the assets away or settles them into the trust) and the beneficiaries- the people who may benefit. The protector is a fourth person sometimes present but not strictly necessary to have a valid trust. These parties are discussed further in Section 3 below.

1.2. Reasons for using trusts

(a) Non-tax reasons.

There are a number of non-tax reasons why wealthy (and not so-wealthy) people use trusts. The following are some of the most common reasons:

(1) To provide for the settlor's children and remoter issue in an orderly way. Often it is undesirable for the settlor's children to receive a large amount of money outright, even once they have reached the age of 18 or 25. Some of them may be especially vulnerable but even if they are not, a trust allows for others – in the form of trustees – to safeguard the capital and ensure that it is not squandered. The trustees will often have a discretion as to when to give the capital to beneficiaries outright. If the trustees do not think that the beneficiaries are ready to receive a large sum of money they can delay advancing capital to a later date. A trust deed may give trustees considerable discretion as to how much capital and income is

[3] See Article 2 of the Convention on the Law Applicable to Trusts and on Their Recognition enacted as part of English law and extended by the Recognition of Trusts Act 1987

paid between beneficiaries and allows them to cater for different personal circumstances. One beneficiary may be disabled and need more than another.

(2) Asset protection. To protect against the risk of bankruptcy or divorce. Once the settlor gives away the property that is transferred irrevocably into the trust, it is generally not considered to be his, assuming he is excluded from benefit. A wealthy person may feel more inclined to take risks on how they invest other assets if they feel they have provided for their children securely. In some cases a trust for children set up before they marry may provide protection against claims on a later divorce.

(3) To avoid forced heirship rules. A number of countries provide that a person must pass a certain proportion of their wealth to heirs in certain specified shares on death. The settlor may want to deal with that wealth differently and in some, albeit not all cases, this may be possible by settling the property into trust during lifetime.

(4) To provide for ease of inheritance. It can often be simpler to settle property into trust before death rather than passing it by will. This can avoid double taxation that would otherwise be incurred where heirs are scattered across different jurisdictions - some countries may tax the donee (the person receiving the property) on the inheritance while others may tax the donor (the person giving the property).

(5) A trust set up before death which holds the assets so they do not pass by will can avoid complex, expensive and lengthy probate formalities. If the property passes by will then each piece of property situated in a different territory has to be dealt with according to the probate laws of that particular jurisdiction often with the will being proven separately each time. Sometimes a will is valid in one jurisdiction but not another. A trust that is set up and holds the assets prior to the death can avoid these difficulties. These problems are particularly relevant to the wealthy who commonly hold assets situated in different jurisdictions.

(6) Wealth management. For very wealthy families it is undesirable that all the wealth is divided among one generation or held for a single person. For example there may be a very valuable business which one of the children manages but it is still felt fair that the capital should be held for the benefit of the wider family rather than all going to that one child. Such is particularly true of farms and family businesses. This can also avoid family disputes.

(7) Asset partitioning (e.g. splitting income and capital). It can be desirable to provide that income goes to one person and capital to another. For example, on second marriages the deceased might want to ensure the second spouse is financially secure and give them an income interest but still ensure that the capital passes on death of spouse to the children of the first marriage and not to the second spouse. Again this can also avoid family disputes.

(8) Flexibility. The settlor may die with very young children and it is not clear yet who is going to be able to take over the family business (if anyone). Some children may turn out to have significantly greater needs than others. The settlor will not know how to cater for future events but prefer instead to appoint close friends or professional advisers as trustees who can then be given discretion to hold income or capital in trust while the children are young and provide for their future sensibly.

(b) Tax reasons for trusts

As a very general observation, since the IHT changes to trust taxation in 2006 (see below) UK resident and domiciled settlors are more likely – given the complexity of UK trust taxation and the fact that trusts are perceived to be taxed more adversely in some respects than outright gifts

– to use trusts for non-tax reasons and only where absolutely necessary. Other vehicles tend to be used to try and achieve the same non-tax advantages such as a family investment company. The 20% IHT entry charge set out below is particularly off putting. However, trusts are still used on death in a will and some lifetime trusts do not actively disadvantage the settlor compared to an outright gift; equally trusts do not generally confer additional tax advantages over an outright gift.

However, there are considerable UK tax advantages for the foreign domiciled settlor who is UK resident or where there are UK resident beneficiaries in setting up non-UK resident trusts. These advantages are discussed in Appendix B.[4]

A consultation on the tax reform of trusts was published by HMRC in autumn 2018[5] 'inviting views on the principles that government believes should underpin the taxation of trusts: transparency, fairness and simplicity'.

The Consultation Document notes:

> *5.2 The policy principle underlying the taxation of trusts is therefore neutrality: the starting principle is that tax should neither encourage nor discourage their use and only deviate from this principle where there are clear policy reasons to do so.*
>
> *5.3 However, the complicating factor when assessing neutrality is determining which comparator to use. It is possible to approach trust taxation as though the property and/or income of the trust still belongs to the settlor – because the property has not been given outright to the beneficiaries. Alternatively, the property and/or income could be considered to be given free and clear to the beneficiaries without the use of a trust. These different comparative scenarios can give very different results, as can a third option of taxing the property or income as belonging to, and only to, the trustees themselves. Which of these possible approaches is genuinely 'neutral' depends on the specific terms of the trust and the circumstances of the persons in question.*[6]

The above paper rightly identifies the problem of determining what is the appropriate comparison to use. But it suggests that the appropriate comparator is with an outright gift to the beneficiary or retention of ownership by the donor. That may not be the right question to ask. As noted above, a trust is not equivalent to the settlor retaining ownership nor is the same as the individual receiving something outright. Ownership, control and benefits are split in varying degrees depending on the nature and terms of the trust. This makes them particularly problematic to tax coherently and in a non-arbitrary way.

1.3. Trust law basics

(a) Parties to a trust

(i) The Settlor

The *settlor* of a trust is the person who provides the trust property. There can be more than one settlor and the settlor can be an individual or a company. If A has £100,000 which he wants to

[4] Broadly, these regimes allow a foreign domiciled person to keep assets outside the scope of UK tax by giving them away to a trust before he becomes domiciled (or deemed domiciled) in the UK. The settlor is still able to benefit from the trust but will only be taxed when he receives benefits.
[5] HMRC (2018) https://www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review
[6] ibid

give to a trustee, B, to hold for the benefit of C, it is common to speak of A 'settling' the £100,000. Similarly, A is referred to as the settlor. There are a number of significant tax consequences in being the settlor of a trust. Further, for tax purposes you will usually be considered the settlor even if you use someone else as a conduit for putting the money into a trust. For example, A gives £100,000 to B and tells B to give it to C to hold on trust for D. A not B is the settlor. Note that if trustees of trust 1 transfer property to trust 2 by way of resettlement the trustees are not the settlors of trust 2. The settlor of trust 1 is also the settlor of trust 2 property (at least to the extent that this property is derived from trust 1).Trust 1 trustees are merely exercising their fiduciary powers over property vested in them by the settlor.

It is sometimes suggested that the settlor really controls the assets. To the extent that the settlor is a trustee or has set out the terms of the trust in the trust deed or expresses wishes in a letter to the trustees this is superficially true. There are certainly trusts (often set up by settlors in a civil law country who have little familiarity with trusts) where the powers reserved to the settlor are so extensive and the trustees' discretions in reality so limited that the trust is vulnerable either to a sham attack or the trust is "illusory" as set out in the *Pugachev* case referred to below. [7] Mowbray et al. (2020), the authors of *Lewin on Trusts* 20th Edition, doubt the decision and comment as follows at 5–035:

> *We do not consider that the reservation to the settlor even of very considerable rights and powers would make the trusts illusory during the settlor's lifetime unless the settlor was the absolute equitable owner of the trust property during his life....it is best not to use the phrase "illusory trust" to describe the result of a determination ... that the settlor has failed to part with the beneficial interest in the trust property; if there is no valid trust other than an absolute trust for the settlor, that is all that needs to be said.*

In short, if in substance the deeds allow the settlor to retain complete control and ownership of the assets then no substantive trust has been created.

Similarly, difficult issues arise in relation to US 'grantor' trusts where the settlor has power to revoke the trust and usually reserves very extensive interests and powers for himself during his lifetime. This can turn what looks like a settlement into a will as it is not effective until the settlor's death.[8] However, there are many variants on the spectrum: a mere power of revocation is not enough to make the trust invalid or a sham although it may make the trust assets available to creditors.[9]

Equally there are many more trusts where the settlors do not retain control and are not even trustees even if they retain powers to appoint trustees (a power which in itself is a fiduciary one and must be exercised in good faith). Moreover, the terms of the trust deed may confer very wide powers on the trustees that may be varied later by the trustees acting alone. So in a properly managed trust which is not a sham or illusory, a settlor is in reality 'trusting' the trustees when assets are placed under their control.

(ii) The Trustees

A *trustee* is the person who owns and controls identifiable trust property. The trust itself does not have legal personality and so unlike a company cannot control property on its own behalf or

[7] See also *Re AQ Revocable Trust* [2010] 13 ITELPR 260 (Bermuda)
[8] See further Mowbray et al. (2020), *Lewin* at 5-036 onwards for further discussion.
[9] In the Bahamas, Bermuda and Cayman Islands there are express statutory provisions to specify that the reservation of extensive powers by the settlor does not invalidate the trust and presumably that would prevent a similar result arising as in *Pugachev* where the lifetime trust is established in that jurisdiction. See for example the STAR Trust jurisdiction in the Cayman Islands.

own property as a legal person. It acts through the trustees. It is the trustees who are recorded, for example, as the legal owners of land at the Land Registry and are empowered to sign cheques from a trust bank account. They manage the trust's affairs. Their administrative and fiduciary powers are set out in the trust deed and amplified by case law and statute – governed by the particular law to which the trust deed is subject. (A trustee may be resident in a particular jurisdiction such as Jersey or Guernsey but be trustee over a settlement which is subject to English law.). Trust property does not belong to the trustee personally and cannot be administered as such. The trustee is a fiduciary i.e. someone who must act in the interests of the beneficiaries ahead of themselves and who owes duties of good faith to the beneficiaries. These duties have been laid down over the years in case law and statute.

As the trustees owe fiduciary obligations, two principles follow. Firstly, without express authority in the trust deed the trustee is not allowed to put himself in a position where his personal interest or interest in another trust conflicts or may conflict with his position as trustee of this trust. Hence even if land is sold at full market value to the trustee or in an auction to him or to another trust where he is the trustee, the sale is voidable and can be set aside at the instance of a beneficiary. Secondly, even if the trustee acts in good faith, in the absence of express provision, he is not allowed to derive any personal advantage (e.g. retention of directors' fees or appointing assets to himself) from the use of trust property or by virtue of his trusteeship. He may not make unauthorised profits by using his position as trustee. Historically therefore a trustee was not entitled to remuneration unless this was expressly provided for in the trust instrument as he could not profit from his trust; this strict rule has now been modified for English law trusts.

There may be any number of trustees (although in the case of land situated in England only four can be shown on the legal title for a non-charitable trust.) Sometimes the trust instrument sets out the minimum or maximum number of trustees. Unless otherwise specified in the trust deed, trustees of an English law private non-charitable trust must act unanimously. A settlor can be a trustee as can a beneficiary (although there are certain restrictions if a beneficiary is later appointed as trustee – in the absence of express provisions permitting this, a beneficiary cannot as trustee appoint in favour of himself.) [10] Sometimes it is specified in the trust deed that a minimum number of two trustees is required to perform a valid appointment or that all trustees must be independent.

A consequence of the fiduciary relationship between a trustee and the beneficiaries is that the trustee must personally account to the beneficiaries if the trustee acts in breach of trust. It is common for the trust document to exclude personal liability of the trustees unless they are negligent or fraudulent but there is 'an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees and the trustees only owe duties to the settlor there are no trusts'. [11]

<u>(iii)</u> <u>Beneficiaries</u>

The *beneficiaries* are the persons (or 'objects') who benefit from the trust. A requirement for the existence of a valid trust is that the objects are defined with sufficient certainty. This means that a trust set up for purposes, rather than for the benefit of persons, cannot normally exist as a trust. So a trust 'for the benefit of Alice and Ben' is fine; whereas a trust 'to further international

[10] See *Brakspear v Ackland* [2008] EWHC 220

[11] Armitage v Nurse *[1998] Ch 241 at 253 CA.*

relations with the USA' is problematic.[12] This is because under English law at least, a purpose trust cannot be enforced by the beneficiaries. [13]

Charitable trusts are a significant exception to the general rule against 'purpose trusts'. To be a charitable trust the trust must comply with the requirements of ss.2–4 Charities Act 2011 and the Charity Commission and Attorney General effectively have the power to enforce the trust and ensure the trustees are accountable.

A beneficiary is a person with proprietary rights in the trust property (or trust fund). The trust deed may identify a class of beneficiaries e.g. 'the issue of the settlor born now or during the Trust Period' which would include all descendants or simply name them 'the children of X being Mary, Jane and Jack'. Some trust deeds contain power for the trustees (sometimes with the consent of the settlor or protector) to add or exclude beneficiaries. Beneficiaries may be entitled only to income or capital or both e.g. 'to Anne to pay the income to her for life and subject thereto to pay the income to Bertrand for life and then to Anne's children living on Bertrand's death in equal shares absolutely'. Anne and Bertrand have income interests only. Anne's children have contingent capital interests. They must survive Bertrand before they can receive anything. It is not possible to know until Bertrand's death who will take what. Anne may have more children while alive and some may die before Bertrand.

If the trust deed was reworded 'to Anne for life and subject thereto to her children Mary, Jane and Jack in equal shares absolutely' the position would be subtly different. Mary, Jane and Jack have vested interests in the capital and even if they die before Anne their estates will receive the property. As no one else can benefit (because even if Anne has more children they are not named as beneficiaries), Anne, Mary, Jane and Jack are absolutely entitled between them and can if they wish being the trust to an end.[14]

(iv) Protector

A *protector* is less common in English law trusts where often family members act as trustees but found more often in offshore trusts where settlors are trusting their money to professionals whom they do not know. The protector can give the settlor some comfort that there are external controls on the trustees. Sometimes a committee acts as protector. The role of the protector is generally to consent to the 'big' decisions affecting the trust, such as who should be given a large amount of capital. The protector's consent may be required for matters such as the addition or exclusion of beneficiaries. The role is not generally to exercise discretions or initiate action but rather act as a curb on trustees although the protector still has to act in good faith and so is some form of fiduciary.

Usually the protector will have power to appoint and replace trustees. The settlor or one or more of the beneficiaries may be a protector. The settlor may choose not to be a protector but could (if the trust deed so provides) retain power to appoint a protector (thus setting up a series of different controls over the trust). The trust property is not vested in the protector.

As noted earlier, recent cases have held that where the settlor as protector holds wide powers, including the power to appoint and remove trustees 'with or without cause' and extensive veto powers over trustee powers of distribution then if the powers are personal rather than fiduciary then the trusts can be illusory (i.e. the powers reserved to the settlor are such that he has in

[12] Re Astor [1952] Ch 534.
[13] In some jurisdictions purpose trusts are now allowed provided an enforcer is appointed. See for example Jersey.
[14] *Saunders v Vautier* (1814) 4 Beav 115; *Re Smith, Public Trustee v Aspinall* [1928] Ch. 915.

reality not divested himself of control over the trust property and has retained beneficial ownership of the assets). See *JSC Mezhdunarodniy Promyshlemniy Bank v Pugachev* [2017] EWHC 2426 (Ch).

(b) Establishing a Trust

In order to establish a trust validly, the settlor must comply with the 'three certainties': certainty of intention, certainty of subject matter, and certainty of object.

Certainty of intention refers to the need for the settlor to show that they intended to create a trust. There is a line of cases which discuss what form of words must be used to show that a trust was intended. In the vast majority of express trusts this will cause no issues as the relevant document ('the trust deed') will state, for example, 'I transfer to B to hold on trust for C' or 'I declare that I hold my house on the following trusts for D'.

Certainty of subject matter means that it must be certain which property is in the trust. Generally, this means that the trust property must be ringfenced and available only for trust purposes. A trust will fail if it is not possible to say which property is held on trust and which property is the trustee's own personal property. The Trust Fund is the term used to describe the trust property comprised in the settlement. Note that the trust property may be held in an underlying company 100% owned by the trustees.

Certainty of objects means that the beneficiaries must be certain. The rules in this area are complex and depend on the precise type of trust being considered. For the most part, it is sufficient that the beneficiaries are ascertained or ascertainable. If all of the possible beneficiaries are expressly named in the trust document, then no problem arises. It is also possible for the beneficiaries to be ascertainable by a certain description. For example, the trust might be for the benefit of anyone that is employed by the settlor on a certain date or for the issue of the settlor born before the end of the trust period (in English law usually 125 years).

All of the above is generally set out expressly in a document called the trust deed although some trusts arise by operation of law without the need for such a deed. A trust deed is effectively the constitution of a trust in the same way as the memorandum and articles are the constitution of a company. The trust deed explains who may benefit under the trust, the powers and duties of the trustees, who may appoint and sometimes remove trustees. Under English law a trust can now last up to 125 years. In practice many end much sooner.

The trust deed itself may confer very wide powers on the trustees to allow them to change the terms of the trust through various powers of appointment. The trustees may be given power to pay out capital to beneficiaries, to pay or withhold income, to end the trust or to move the assets to another trust. Trustees may be given power to add or exclude beneficiaries. However, in other cases the trustees' discretions and powers will be quite limited. Much will depend on how much power the settlor initially wanted to confer on the trustees. In some cases, the settlor may have conferred very wide powers on the trustees but later the trustees have deliberately narrowed their powers either for tax or other reasons. Hence the terms set out in the original trust deed are likely to change considerably over the years to cater for future events and the needs of beneficiaries. Although the trustees may initially follow the settlor's wishes these may prove inappropriate as future events unfold.

The beneficiaries do not control directly how the trust property is used but have a right to ensure that the trustees use it for their benefit as set out in the trust deed or any later appointments. The beneficiaries are therefore not like shareholders as they do not have voting rights; the extent of their interests may be quite uncertain and contingent. The trustees are not exactly equivalent to the directors of a company. The trustees owe a higher standard of care to the beneficiaries and are regulated by different case law and statute.

(c) Types of trust

These can be divided into discretionary, and interest in possession (sometimes called life interest) trusts. Discretionary trusts may give trustees complete discretion over income and sometimes also capital. Interest in possession trusts mean a trust where one or more named beneficiaries have the right to receive the trust income. But this simple division fails to properly comprehend the huge variations between trusts. Discretionary trusts can be quite restrictive in terms of what discretions the trustees actually have. Life interest trusts may in practice confer on the trustees very wide discretionary powers over income and capital. The 'type' of trust is determined initially by the terms of the trust deed (being the constitution of the trust) and by general law. Over time the type of trust may well change as the trustees exercise their powers of appointment to take away or confer a life interest. Some of the common forms of trust are below. In some cases the type of trust used will affect the tax treatment in the UK and elsewhere.

(i) Discretionary trust

A discretionary trust normally gives the trustees the discretion to favour one beneficiary over another, or act to the complete exclusion of another. e.g. 'the trustees shall pay or apply the trust fund and the income of the trust fund to B1 and B2 as the trustees see fit'. The effect of this is that until an appointment is made, neither B1 nor B2 has any right in the income or capital of the trust fund, which has traditionally made such trusts difficult to tax. The trustees may have discretion to add and exclude beneficiaries. The trust document might be discretionary as to income but vest capital in named persons after a certain period e.g. the trustees may pay or apply the income to B1 and B2 as the trustees see fit in their absolute discretion but on the expiry of 21 years the trustees shall pay the capital to B1 and B2 in equal shares. This discretion cannot be exercised for an improper purpose or to benefit a non-beneficiary.

In some cases, the trustees may have discretion over who receives income e.g. Trustees must pay the income to B1 or B2 each year as they see fit, and have no power to accumulate such income. They must pay all income out but have discretion over who receives it. More commonly, trustees have power to accumulate the income and add it back to the capital of the trust fund.

(ii) Interest in possession trust (sometimes called life interest trust)

Under this type of trust one or more beneficiaries has the right to the income of the Trust Fund as and when it arises under the trust and the trustees have no discretion whether to pay out the income (although they may have power to revoke that interest in possession). The person who is entitled to the income is often called the life tenant but in fact the income may be paid only for a fixed period e.g. ten years or the income interest may be revocable. Hence it is not the case that all interests in possession continue for a person's life.

The trustees can ensure that little income arises at the trust level by inserting a holding company between the trustees and the underlying trust property. The income passing up to the life tenant can then be controlled by controlling the flow of dividends from the holding company up to the life tenant.

(iii) Accumulation and maintenance trust

This was broadly a hybrid of a discretionary trust and interest in possession trust. It was a creature of IHT legislation and gave favourable IHT treatment to trusts for young people – typically children or grandchildren of the settlor. The rules were arcane but broadly operated as follows: until the beneficiaries reached the age of 25 the trustees could accumulate or pay out income at their discretion. After reaching that age, the beneficiaries had to become entitled to income. Capital entitlement could be deferred indefinitely. Accumulation and maintenance trusts cannot be set up on or after 22 March 2006 with the same IHT advantages and depending on a number of conditions, existing ones set up prior to that date will either fall within the relevant property regime or the qualifying interest in possession regime for IHT purposes. See tax position at 4(a) below for a discussion of these IHT terms.

(iv) Bare trust

A bare trust means that the trustees have no more than the 'bare' legal title. They must do what the beneficiary tells them to do in relation to the trust property and have no discretion. The beneficiary has outright ownership.

Bare trusts may be used to hold property given to minors or where the 'real' or 'beneficial' owner wants to hide their identity or operate as 'blind' trusts where politicians or those with potential conflicts of interest in their public duties have to ensure personal investments are held in the bare trust. The beneficial owner not the trustee remains liable for all taxes just like any other owner but the trustees have control over investments.

(d) Some examples of trusts in practice

(1) Property is settled in 2010 inter vivos (during the settlor's life) by X as settlor on trust for A for life remainder to B and C absolutely in equal shares. (This is a 'fixed' interest in possession trust). If A, B and C are adult they can between them bring the trust to an end[15] but until they do so the property continues to be settled. It is in UK IHT terms a non-qualifying interest in possession trust.

(2) Property is held on trust for 'such of A, B, C, D, E and F as my trustees in their absolute discretion may select' (this is a discretionary trust).

(3) Property is held on trust by A and B as trustees for Z absolutely (a bare trust). For tax purposes there is no settlement and the property is treated as belonging to Z.

(4) A settles property in his will on 'trust for my wife for life and then to my children absolutely' but with overriding powers of appointment given to the trustees enabling them to vary or end the trusts at any time during the trust period defined as 125 years from A's death. While the wife is alive and retains the life interest there is a qualifying interest in possession but the trustees retain powers to end her life interest at any time. In a sense this Is a hybrid trust because the trustees in reality have wide discretions. However, while the life interest continues the trustees must pay the income to wife. If they exercise their overriding powers they cannot deprive wife of income which has already arisen but can stop her receiving future income.

(5) A settles Blackacre 'on trust for B for life and then to C but subject to my power to revoke the settlement at any time'. This is settled property[16] and A is not treated as owning the property (although he may have reserved a benefit in it for IHT purposes given that he has power to benefit from it). See further below.

[15] See *Saunders v Vautier* (1841) 4 Beav 115.
[16] See *Perry v Astor* (1935) 19 TC 255.

1.4. UK tax position of trusts

The UK taxation system of trusts is complex. The general approach over the last twelve years has changed and UK resident trusts at least tend to be taxed as a person in its own right rather than by reference to the status of the beneficiary or settlor. Having said that, the position is not consistent across the taxes.

The difficulty with taxing trusts is that there are a number of different variables which affect how a trust should be taxed. Those variables include the following:

(1) Domicile of the settlor (where his permanent home is) and residence of the settlor;
(2) Situs (legal location) of assets in the trust;
(3) Residence and domicile of each beneficiary;
(4) Residence of the trust (determined by reference to the residence of the trustees[17]);
(5) Whether the settlor can benefit from the trust;
(6) Whether a beneficiary is entitled to receive income, capital, or other benefits.

The following table broadly indicates in very simplistic form which factors are relevant for each tax in relation to UK resident trusts:

	IHT	CGT	Income tax
Domicile of settlor	✓	Irrelevant	
Residence of settlor		Irrelevant	✓
Situs of assets/source of income	✓	Irrelevant	✓
Residence and domicile of beneficiary	✓ (in limited cases non-residence can avoid IHT)	Irrelevant	✓
Whether settlor can benefit	✓	Irrelevant	✓

The following table indicates which factors are relevant for each tax in relation to non-UK resident trusts:

	IHT	CGT	Income tax
Domicile of settlor	✓	✓	✓
Residence of settlor		✓	✓
Situs of assets/source of income	✓	Only in relation to UK land	✓
Residence and domicile of beneficiary	✓ in limited cases residence of beneficiary is relevant	✓	✓
Whether settlor can benefit	✓	✓	✓

What follows is a very simplified survey of the UK tax position of trusts.

[17] The residence of the trustees in itself can be complicated and a detailed survey is outside the scope of this note. For simplicity it should be assumed that the residence of the trustees is broadly where the trustee is resident. If none of the trustees acting are UK resident then the trust will not be UK resident.

(a) Inheritance tax (IHT)

Most lifetime transfers into trusts of any sort (whether discretionary or interest in possession) set up by a UK domiciled settlor[18] are now subject to an entry charge of 20% for assets of over £325,000[19] with an additional 20% payable if the settlor dies within seven years. This contrasts with the so-called 'PET' or potentially exempt transfer regime which allows lifetime gifts between individuals (not in trust) to be free of any IHT provided the donor survives seven years. Further, there will be another tax charge at up to 6% on each ten year anniversary from the start of the trust and exit charges of up to 6% (in practice often much less[20]) when capital distributions are made from the trust. These IHT rules are known as the 'relevant property regime'. The relevant property regime only applies if the transfer is either (i) made inter vivos on or after 22 March 2006 into an interest in possession or discretionary trust or (ii) made prior to that date whether by lifetime or death transfer and into a discretionary trust AND either :

(a) The settlor is UK domiciled or deemed domiciled when the trust is established or funded[21] OR

(b) The settlor is foreign domiciled when the trust is established or property is added when foreign domiciled AND the trust fund comprises in whole or part UK situated property or schedule A1 property. Schedule A1 property broadly means a foreign company directly or indirectly held by the trustee that owns UK residential property or loans to purchase the same.

Note that the residence of the settlor and the trustees are both irrelevant for UK IHT purposes.

Trusts set up by UK domiciled settlors now tend to be confined to 'nil rate band' trusts where the settlor gifts £325,000 into trust every seven years or the settlor gifts property that qualifies for full 100% relief (such as business or agricultural property) as this avoids the 20% IHT entry charge. Otherwise most trusts made by UK domiciled settlors are settled by will where the tax regime is different. Disabled trusts also qualify for a special regime outside the scope of this note.

Prior to 22 March 2006 interest in possession trusts had a very different inheritance tax treatment from discretionary trusts. From this date, the position changed. Property settled into a life interest trust *by will* and any interest in possession trust set up and funded during the settlor's lifetime or on his death *prior to* 22 March 2006 continue to be treated for inheritance tax purposes as if the life tenant owned the underlying capital ('qualifying interests in possession').

[18] See Appendix B for meaning of domicile

[19] There is a renewable nil rate band every seven years which broadly allows each individual to give assets into trust up to £325,000 every seven years at 0% although there are exceptions to this outside the scope of this note.

[20] Because of the way in which the charge is calculated – if, for example the distribution is made shortly after a ten year anniversary the exit charge will be very small as it increases the longer the property is held in trust after each ten year anniversary.

[21] There are some complicated new rules following changes in FA 2020 to tax trusts funded when the settlor was foreign domiciled that transfer property to a new trust after the settlor has become UK domiciled or deemed domiciled. There are also some exceptions where the settlor was foreign domiciled when he settled property into a pre March 2006 interest in possession trust for himself or spouse but when the IIP ends the settlor or spouse is UK domiciled. See s80 IHTA 1984.

Most inter vivos interest in possession trusts settled after 22 March 2006 are 'non-qualifying' and will now be taxed for IHT purposes in the same way as discretionary trusts as part of the relevant property regime, i.e. IHT is charged on the trustees and not on the beneficiaries.

If the UK domiciled settlor can benefit from the trust fund at any time in the seven years prior to his death then additional charges arise at up to 40%. This is the 'reservation of benefit' regime.[22] See Example 1 below.

If the settlor is not UK domiciled then non-UK assets[23] can be settled into trust without any 20% entry charge, the settlor can benefit without IHT difficulty and there are no ten year or exit charges. This is called the 'excluded property regime' for IHT purposes. See Example 4 below.

(b) Capital gains tax (CGT)

UK resident trustees are taxed as a separate body of persons even if the settlor can benefit. This is a change since 2008. The gift into the trust is a disposal and the donor can pay tax on the gain. In some cases, it may be possible to 'hold over' the gain so the trustees take the asset at the settlor's historic cost.

If trustees themselves make a gain on an investment, they will be charged CGT on that gain at 20% or 28% (if residential property) when they sell it. They have a limited annual exemption.[24] When the trustees appoint property other than cash out of a trust to a beneficiary, they are charged on any gain on the asset assessed at market value. Again in some cases it may be possible to hold over the gain. Beneficiaries of UK resident trusts are not taxed on trust gains and generally are not taxed on disposals of their interests in settled property (e.g. where a life tenant assigns their life interest to someone else.)

If the trust is non-resident then if the settlor is domiciled and resident in the UK the gains of the trust are taxed on the settlor[25] even if the settlor/spouse/civil partner are wholly excluded. It is enough that *any of* the settlor/spouse/civil partner/children/grandchildren or respective spouses/civil partners can benefit. If the trust is non-UK resident and the settlor is dead, non-UK resident or non-UK domiciled, then trust gains can largely be rolled up tax free.[26] They are only taxed when capital distributions are made to UK resident (and domiciled) beneficiaries.[27] The CGT regime for non-resident trusts is highly complex.

(c) Income tax

For income tax purposes, the trustees are taxed as a separate body of persons unless the settlor or spouse/civil partner can benefit. Trustees of UK resident discretionary trusts pay tax at the highest income tax rate on most of their income (45% or 38.1% on dividends). If income is then paid out to the discretionary beneficiary, that beneficiary receives a credit for the income tax paid by the trustees (but with certain complexities). In the case of interest in possession trusts (whether qualifying or not) the UK resident trustees broadly pay at 20% (7.5% on dividends) and then the income is taxed on the life tenant with a credit for the tax paid by the trustees.

If the settlor/spouse/civil partner can benefit from the discretionary trust and it is UK resident then the income is ultimately charged at the settlor's rate albeit the process for collecting the

[22] See FA 1986
[23] Other than schedule A1 property e.g. foreign companies holding UK residential property.
[24] Half that of the individual annual exemption and reduced further if the settlor has set up more than one trust.
[25] TCGA 1992 s86
[26] There is an exception for disposals of UK land.
[27] TCGA 1992 s87

tax is cumbersome.[28] Given the trustees pay tax at the highest rate anyway this anti-avoidance provision seems unnecessary for UK trusts but has not been repealed.

In the case of non-resident discretionary trusts if the settlor is UK resident and domiciled and the settlor/spouse/civil partner can benefit from the trust in any circumstances then both the income of the trust and the income of any underlying non-UK resident company owned by the trust can broadly be taxed on the settlor. If the settlor/spouse/civil partner are all excluded then non-UK source income can be rolled up tax free in the non-resident trust/company. However, when distributed to UK resident and domiciled beneficiaries whether as income or capital it will be taxed on them. [29]

1.5 Examples

(1) Giles, a UK resident and UK domiciliary, settles a picture worth £1 million into a UK resident discretionary trust where he can benefit along with his descendants. He has made no previous gifts. The picture is worth £1 million and shows a gain on the gift by Giles of £200,000.

There is no hold over relief as the trust is a settlor interested trust. The trustees acquire the picture at market value of £1 million. Giles pay CGT of £40,000 on the gift. The trust pays CGT on a future disposal if the picture is sold for more than £1 million.

Income from the trust (if any) is taxed on Giles under the settlement provisions in ITTOIA 2005 although he has a right of reimbursement from the trust.

The transfer is an immediately chargeable transfer for IHT purposes – there is a 20% entry charge on the excess over his unused nil rate band. (Giles pays the IHT with grossing up at an effective rate of 25%).

Giles dies 12 years later. There is a reservation of benefit (ROB) for IHT purposes. Hence a further 40% is payable on Giles' death on the value of the trust assets with no spouse exemption and no CGT uplift – the liability falls on the trustees not Giles' estate.

Throughout the life of the trust including while Giles is alive ten-year and IHT exit charges at up to 6% are payable

(2) Giles is excluded but wife remains a beneficiary. Trust is UK resident. Giles is UK resident and domiciled.

Giles avoids 40% IHT on his death but all the other taxes including income tax remain.

(3) Giles and wife excluded. Trust UK resident.

No IHT arises on Giles' death but otherwise 20% IHT remains on entry into the trust and on the ten year anniversary and on distributions (6%). Giles pays CGT on gift of picture. Trustees pay CGT on later disposal of picture for a gain. Income tax – trustees pay at 45%/38.1% on any trust income.

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[28] See the settlements legislation in ITTOIA 2005 s620 onwards.
[29] There are complex anti-avoidance provisions for non-UK resident trusts including the ability to tax UK resident beneficiaries who receive capital distributions by reference to the income of any underlying company. See Transfer of Assets legislation in ITA 2007.

(4) Giles is foreign domiciled but UK resident and settles the picture into a non-UK resident trust.

Assuming the trust held the picture or any substitute assets outside the UK at all times, there would be no IHT at any point including on his death, no CGT on settlement of the picture or on realisation of any gains (unless he received a benefit in the UK) and no income tax on trustees or Giles. The trust is an excluded property trust for IHT purposes.

(5) Giles is UK domiciled and UK resident and settles the picture into a non-UK resident trust from which he and his wife are excluded.

There is no difference in the IHT position from (3) above. Giles also pays CGT while alive on any gains realised by the trustees. For income tax purposes the trustees pay tax only on UK source income.

2. Foundations

Other jurisdictions have different ways of splitting legal ownership and benefit. These are similar but certainly not identical to a trust. Given that a number of UK-resident but non-domiciled individuals will have an interest in these entities, the UK tax code needs to decide how they should be treated for UK tax purposes. No settled position has yet been arrived at for these entities: they are characterised in one way for one tax and in a different way for another.

2.1 Introduction

Foundations are not an entity formally recognised under UK law. They are creatures of statute and the legislation of each jurisdiction differs. They are most associated with Liechtenstein but are also found in other civil jurisdictions such as Austria; Switzerland; Panama; St Kitts; Seychelles; Nevis; Anguilla; Antigua; Malta; and the Netherlands Antilles. Jersey and Guernsey recently introduced legislation allowing the establishment of foundations.

2.2 Features

Like a company, a foundation is a separate legal entity which owns assets in its own right. The foundation can only be liable for debts up to the value of those assets. This is in contrast to trusts where trustees do not have separate legal personality; do not beneficially own the assets; and can be made personally liable for trust debts. A foundation is incorporated by entry on a register and, like a company, has a name and registration number and is a separate legal entity. It is a body corporate in Liechtenstein. However, unlike most companies other than those limited by guarantee it has no shareholders: it is not ‘owned’ by anyone. It can last indefinitely.

The ‘founder’ (equivalent to a settlor) provides the assets and sets out in the declaration or articles (similar to a memorandum and articles of association) how the assets should be administered and how they should be dealt with while he is alive and after his death. There may also be bye-laws supplementing the articles. The founder often reserves certain powers in the articles such as power to change the bye-laws: revoke or add or exclude beneficiaries; or remove the foundation council (this is the administrative body: sometimes called a board).

It may have named beneficiaries or be established for specified purposes. For example, some foundations are used like a purpose trust as the holding vehicle for the shares in a private trust company which in turn acts as trustee and holds the assets of the family.

It is not always clear what rights if any beneficiaries have against the council to enforce the terms of the foundation nor whether the duties and obligations of the council members are fiduciary or contractual. This can vary from jurisdiction to jurisdiction and from foundation to foundation. If contractual, who can enforce the contract apart from the founder whilst he is alive? It appears that even where the founder has reserved rights to control the council, the beneficiaries often have limited rights to hold the council to account and the foundation is subject to some form of limited official supervision. That does not accord with a trust arrangement where the trustees have an irreducible core of obligations towards a beneficiary who has proprietary rights. See *Armitage v Nurse* above.

2.3 UK tax position

The classification of a foundation for UK tax purposes remains unclear. Is it a trust, company or nominee arrangement for tax purposes? Does its status differ depending on the tax?

In practice, the answer will depend on the jurisdiction and the particular terms of the foundation. In some cases, they are little more than nominee arrangements. Classification may also vary between taxes. HMRC's starting point is to treat Liechtenstein foundations as trusts for UK tax purposes (see Second Joint Declaration by the UK/Liechtenstein issued in 2010 in connection with the Liechtenstein Disclosure Facility[30]) although this statement was heavily qualified: 'The parties recognise that the ultimate UK taxation consequences for UK tax payers will depend on the particular facts relating to specific entities or fiduciary relationships'. The official view of the tax position for foundations in other jurisdictions remains uncertain.

3. Usufructs

3.1 Introduction

Usufructs are commonly found in civil law countries, notably in France, Netherlands, Germany and Spain. Although usually over land, they can certainly be created over moveable property. Article 578 of the French Code Civile provides that: 'an usufruct is the right to enjoy property belonging to another, as if its owner, at the expense of preserving that property'.

The owner of the right is the usufructuary and the owner of the property subject to that right is called the encumbered owner or *nu-proprietaire (holder of the 'bare title')*. The usufructuary is responsible for the upkeep of the property and in most jurisdictions which have a wealth tax is liable to pay wealth tax based on the value of that interest.

3.2 Features

The following features are commonly found:

(i) the usufructuary has the right to enjoy the fruits (use) of the property during his lifetime. This right can be renounced, charged voluntarily and seized by third parties, although it is generally thought to be inalienable because of its connection with the person of the usufructuary;

(ii) the interests of both the usufructuary and the 'bare title owner' are registered in the relevant property register;

[30] https://www.taxation.co.uk/docs/default-source/file/secondjjointdeclarationlich.pdf , p.7

(iii) this division of property title can occur on death (with someone being given a usufruct in the property and other persons given the bare title) or by an inter vivos act of the owner of the property or a buyer;

(iv) on the acquisition of both a usufruct and the bare title, tax will be split and shared between the usufruct and the bare title owners according to a formula which takes the age of the usufructuary as the working base;

(v) on the death of the usufructuary this ‘interest’ (which will cease) does not form an asset of his estate. Hence no probate is needed in respect of this asset and the bare owners may then ‘consolidate’ their title at the land registry by producing the death certificate and payment of any transfer tax owing.

3.3 UK tax position

In effect then a usufruct may best be described as an arrangement under which a person has ownership of an asset but that ownership is encumbered in some way by rights of use or enjoyment held by another person – the usufructuary. Usufructs are not specifically addressed in the UK tax legislation and do not easily fit within our current system of taxes. There is no separate legal person or trust holding the property separate from the bare owner and the usufructuary. Although superficially similar to an interest in possession trust there is no trustee or real equivalent of the trustee role and no fiduciary duties are involved between the usufructuary and bare owner.

HMRC currently take the controversial view that a usufruct is a settlement for IHT purposes but not for capital gains tax purposes, a position that is far from accepted. What is clear is that the UK tax treatment of usufructs (not uncommon vehicles for foreigners living in the UK who may be deemed domiciled for inheritance tax purposes) is unclear and potentially penal.

Appendix B: The meaning of residence and domicile – UK tax implications

Emma Chamberlain

1. Overview of tax position

There are three important connecting factors that govern whether and how someone is liable to direct taxes in the UK. These are:

(i) domicile;

(ii) residence; and

(iii) situs of asset (in which country is the asset situated) or source of income.

1.1 Income tax and CGT positions

In broad terms, all three factors are important for income tax and capital gains tax (CGT) purposes although if the individual is non-UK resident then domicile ceases to be important. Those resident and domiciled in the UK are taxed on their worldwide income and gains. Non-residents wherever domiciled are taxable only on limited sources of UK income. Most capital gains realised by non-residents (except on UK real estate) are in general free from CGT although there are anti-avoidance rules if a UK resident person returns within five years of leaving the UK. The gains realised in the period of absence can then be charged in the year of return.

UK resident but foreign domiciled persons are taxed on UK source income and UK gains but not on foreign source income or foreign gains realised on disposals of foreign situated assets unless broadly they 'remit' or bring the foreign income or gains to the UK, assuming that they claim the remittance basis as described below. From 2008 there are extensive anti-avoidance rules to ensure that remittances of foreign income and gains by persons connected with the foreign dom such as spouse, cohabitees or minor children are also taxed. There are further anti-avoidance rules to determine what is 'clean capital' and what is foreign income or gains.

In addition, the foreign domiciliary must now actually claim the remittance basis and after seven years of UK residence pay an annual 'remittance basis charge' of £30,000 and then (after twelve years) £60,000 to avoid tax on foreign income and gains. The annual charge is additional to any tax payable on actual remittances of foreign income and gains to the UK. Since 2017 a further set of changes were introduced to tax long stay foreign doms – see deemed domicile rules in Section 4 below.

1.2 IHT position

Inheritance tax is not charged on 'excluded property'. Property situated outside the UK is excluded property if the owner of the property is neither domiciled nor deemed domiciled in the UK.[1] Note that someone could be UK domiciled and non-UK resident (subject to IHT) or UK resident and non-UK domiciled (only subject to IHT on the UK estate). Even where the owner is deemed or actually domiciled in the UK in certain cases a double taxation treaty may remove

[1] IHT Act 1984 s.6(1).

the UK's right to tax foreign situs property on death. Equally, even if the individual is domiciled outside the UK, any interests held in foreign companies owning UK residential property are still subject to inheritance tax on the death of the foreign domiciliary wherever resident (schedule A1 property).

Foreign domiciled persons wherever resident are still charged on all UK situated property held directly e.g. UK shares, bank accounts, pictures, houses and land.[2] However, it is relatively easy to 'resite' UK property and avoid IHT by owning it in a foreign incorporated company.

The IHT position is more complicated for trusts. Trusts set up by an individual who was not foreign domiciled when he set up the trust and was not a formerly domiciled resident (see Section 4 below) are permanently free from IHT even if the individual can benefit provided the trust holds no UK situated property directly and owns no foreign company owning UK residential land or loans to purchase the same.[3]

Once the foreign dom has been UK resident for 15 out of the last 20 years, they become deemed domiciled in the UK in their 16th tax year for all tax purposes and will therefore be subject to UK IHT on their worldwide free estate. See Section 4 below. However, there are special protections for trusts set up by foreign doms before becoming deemed domiciled. See Example 14.

This paper explains in some detail the current residence and domicile rules for UK taxpayers and the special tax rules for foreign doms.

2. Residence

The test of whether an individual is resident in the UK for tax purposes has, since 6 April 2013, been determined by statute:[4] The statutory residence test (SRT) is in some ways considerably more generous than other countries in allowing a person to remain physically present for quite lengthy periods in the UK without becoming tax resident. It combines a mixture of time spent in the UK and connecting factors such as house, work or family, in determining UK residence. UK residents wanting to become non-UK resident ('leavers') must spend fewer days in the UK and have fewer connecting factors than those who have been non-UK resident for more than three tax years ('arrivers') in order to be non-UK resident.

Although the residence test has been criticised for its complexity, it is considerably simpler than the position as it stood prior to 6 April 2013, based as that was on outdated case law and misunderstandings over the nature and importance of accommodation. Even how to count days was a matter of some dispute.

The basic rule since 2013 is that an individual is tax resident in the UK if either the automatic UK test is met or the sufficient ties test is met for any part of that tax year unless the automatic overseas test is met. In short, the automatic overseas test trumps everything. If he does not

[2] There are some exceptions, for example authorised unit trusts or shares in an open-ended investment company are excluded if the owner is not domiciled in the UK. A foreign currency UK bank account is left out of account for IHT purposes on death if the individual was neither resident nor domiciled. Certain UK gilts are exempt from UK IHT if in the beneficial ownership of an individual who is not UK resident irrespective of domicile.
[3] IHTA 1984 s.48(3).
[4] Finance Act 2013 Sch. 45. Schedule 46 abolishes the concept of ordinary residence and amends all other legislation that previously referred to ordinary residence. Accordingly it is no longer possible to be resident but not ordinarily resident in the UK.

satisfy either the sufficient ties test or the automatic UK residence test then he will be non-UK resident even if he does not satisfy the automatic overseas test.

A person is treated as UK resident for the entire year (or not UK resident for the entire year) although in some cases it is possible to be resident for only part of the year or be resident in the UK under general law but treaty resident abroad under a double tax treaty. Note that if someone is resident in the UK under general law but treaty resident elsewhere, the year is still counted as a year of residence for the purposes of assessing whether they are liable to the remittance basis charge and counting their years for the purposes of acquiring deemed tax domicile (see below).

The statutory residence tax applies for income tax, CGT and IHT but not for national insurance or for non-tax purposes such as determining the court's jurisdiction in commercial or family disputes. Nor does the statutory residence test apply in determining whether individuals are resident in a particular country in the UK (e.g. in England, Wales, Scotland or Northern Ireland). The rules will also not apply to the proposed additional 2% SDLT charge on non-residents that is due to come into effect next April 2021. A different definition of residence will be used.

2.1 Automatic UK tests

There are four automatic UK residence tests. The more important are:

(a) the 183 day test: has the taxpayer spent at least 183 midnights in the UK in any tax year?

(b) The only home test: broadly has the taxpayer got a UK home and not an overseas home and if he has a home both in the UK and overseas, does he spend sufficient time in the overseas home? If he does not spend at least 30 days in the overseas home and it is not available to him throughout the tax year then he is automatically UK resident if he has a UK home. A home means something more than just accommodation.

(c) Does he work full time in the UK?

2.2 Automatic overseas tests.

There are five automatic overseas tests. The most important are:

(a) If the taxpayer is a leaver (i.e. has been UK resident in any one or more of the three preceding tax years) has he spent fewer than 16 midnights in the UK in the current tax year? If so, he is automatically non-UK resident.

(b) If the taxpayer is an arriver, (i.e. was not resident in the UK for any of the three tax years preceding the relevant tax year and spends fewer than 46 midnights in the UK in the tax year) then he is non-UK resident.

(c) Working full-time abroad.

2.3 The 'sufficient ties test'

Often the taxpayer will satisfy neither an automatic UK test nor an automatic overseas test. In these circumstances, he must look at the sufficient ties test. This is met for a tax year (and the taxpayer is then UK resident) if:

(a) he meets none of the automatic UK tests and none of the automatic overseas tests; but

(b) he has sufficient UK ties for that year.

The sufficient ties test depends on an interaction between the days spent in the UK with the number of other UK ties a person has (called P in the legislation). The more UK ties P has, the fewer days he can spend in the UK without being UK resident. As a general principle, on the basis that leavers must make a 'distinct break', arrivers can spend more time and have more connecting factors in the UK than leavers and still not become UK resident.

No of days spent in UK in Year X	Maximum number of ties allowed if taxpayer is to be non-UK resident	
	Taxpayer was UK resident in any one or more of last three years LEAVERS	**Taxpayer was UK resident in none of last three tax years ARRIVERS**
More than 15 but not more than 45: i.e. 16–45 (inclusive)	No more than three ties	Conclusively non-resident, however many ties.
More than 45 but not more than 90: i.e. 46–90 (inclusive)	No more than two ties	No more than three ties
More than 90 but not more than 120: i.e. 91–120 (inclusive)	No more than one tie	No more than two ties
More than 120	No ties allowed	No more than one tie

The sufficient ties test is therefore structured as a ladder: the key question is day count but other relevant factors are the accommodation tie; 90 day tie; country tie; work tie; and family tie. The more ties an individual has in the UK the less time he can spend here. All this is intended to reflect the case law as it stood before 2013. Hence the statutory residence test is not a pure day count test. However, even leavers can spend up to 90 midnights in the UK without becoming UK resident if they have only two ties here, and arrivers can spend 90 midnights here each year and have three ties here. Moreover, full-time workers abroad can spend up to 90 midnights here without becoming UK resident however many ties they have.

The relevant ties to consider are as follows:

(a) *The family tie.* Are any of P's family resident in the UK in the particular tax year? 'Family' is defined as spouse or civil partner (unless separated); cohabitee or minor child. Note that a minor child who is UK resident because at boarding school does not give a family tie provided that the child spends fewer than 21 days in the UK outside half-terms and term time. Nor is a minor child included if P sees the child in the UK on fewer than 61 days in total in any tax year.

Example 1

Harry is separated from his wife so she is not counted as his family for the purposes of the family tie. However, he has one son who is 15 whom he regularly sees in the UK. That child is counted as a family tie, unless he saw the child for less than 61 days in the UK in the tax year.

(b) *Accommodation tie.* P has an accommodation tie if he has a place to live in the UK which is available to him in the tax year for a continuous period of at least 91 days and he spends at least one night at that place in the tax year. If there is a gap of fewer than 16 days between periods in the tax year when a particular place is available to P, that place is treated as continuing to be available to P during the gap. P does not need to own the accommodation provided it is available to him even if he has no legal right to occupy it. If P stays with close relatives, he is allowed to stay for up to 15 nights without the accommodation being treated as a tie if the close relative is a parent; grandparent; brother or sister or an adult child or grandchild, but not if he stays with a spouse; civil partner; or cohabitee.

(c) *Work tie.* P has a work tie in the tax year if he does more than three hours' work a day in the UK for more than 39 days, whether continuously or not. If he works more than 30 days in the UK, P cannot satisfy the third automatic overseas test (full-time working abroad). However, if he works more than 39 days in the tax year for more than three hours a day, he will have a work tie and will therefore have to include this when deciding whether he satisfies the sufficient ties test.

(d) *The 90-day tie.* P has a 90-day tie if he has spent more than 90 midnights in the UK in either of the last two tax years preceding Year X. The effect of this rule is that in almost all cases, leavers will have at least one tie, the 90-day tie, because they will have spent more than 90 days in the UK in at least one if not both of the two previous years before Year X. Moreover, that 90-day tie will hang over them for the first two tax years after departure.

(e) *The country tie.* This tie is not applicable to arrivers: i.e. people who have not been UK resident in the previous three tax years. For leavers, the tie applies if P spends more midnights in the UK than in any other single country. This is designed to deal with the wanderer who does not base himself anywhere.

Counting days. Many of the pre 2013 tax cases centre on the number of days spent in the UK and some of those cases considered at great length how to count the days: should it be a midnight test, a day of presence test, should days of arrival and departure be included? The statutory residence test takes a sensible approach to this. 'Days' is defined to mean midnights, i.e. a day when P is present in the UK at the end of the day unless he is in transit, in which case the midnight is ignored, or there are exceptional circumstances beyond his control. Up to 60 exceptional days each tax year are allowed. Note that the exceptional circumstances test can only be satisfied if circumstances prevent P from leaving the UK and he does in fact leave the UK as soon as he can. If P comes to the UK to visit a sick relative or because he is ill he cannot claim exceptional circumstances on this basis.[5]

2.4 Examples of how the statutory residence test works

Example 2

Emma, a famous Russian cellist, comes to the UK for the first time in June 2020. She spends 190 midnights here performing in concerts and making recordings in London. She does not have a UK home or family here but stays in a hotel or with friends. She spends the remainder of her time in Russia practising cello studies at her home in St Petersburg. She is UK resident under the first automatic UK test in the statutory residence test (although the double tax treaty will need to be considered to determine her tax treatment since she may be treaty resident in Russia).

[5] In one instance where P has three ties and is a leaver the midnight rule is extended and days of presence can be counted. If the number of days when he is present in the UK (but not for a midnight) is more than 30, in these circumstances, any days over the 30 when P is present in the UK (but not at midnight) are to be treated as a day spent by P in the UK. Note that in counting, the deeming rule does not apply to those working full-time abroad (here it is a 91 midnight test) and it does not apply for the purposes of determining whether someone has a 90 day tie.

Example 3

John, a famous violinist, comes to the UK to make some chamber music recordings with Janice for a few days. His only home is in the UK but he works full time abroad travelling the globe apart from the 25 days he plays music with Janice in the UK. He satisfies both the second automatic UK test (only home) and the third automatic overseas test (work abroad). Henry is therefore non-UK resident as the automatic overseas test overrides the automatic UK test.

Example 4

Tamsin has lived in the UK all her life. She has no close family. She decides to move to Spain. She leaves on March 6 to live in Spain but retains her home in the UK as well as acquiring one in Spain. She does not work full time in the UK. She does not satisfy any automatic UK test. She spends 88 midnights in the UK. In the past two years she has spent more than 90 midnights in the UK. She therefore has two ties in the UK in that tax year (90 days and accommodation). She is not UK resident under the sufficient ties test.

Example 5

Paul and his partner Drew decide to emigrate to France but they still like to visit friends and relations in the UK. When they come over, they return to their UK flat that they have retained as before. They each spend no more than 90 midnights in the UK. They spend the rest of their time in France where they rent a lovely home. They have no minor children. They each have a 90 day tie for the first two years after departure. They also have an accommodation tie. Provided neither of them works here and both remain under 90 midnights for the first two tax years after departure they are not UK resident. They do not have a country tie and they have a home in France even though it is not owned by them so they do not satisfy the automatic UK test.

In the third tax year they can increase their day count to 120 midnights in the UK as they have lost the 90 day tie and only have one tie – accommodation. In the first three tax years they must spend more time in France than the UK. After the third year they become arrivers rather than leavers and can then spend 120 midnights in the UK and retain non-resident status. The country tie is no longer relevant but they must at all times retain and use a home in France.

Example 6

David is UK resident in 2013–14. He leaves in March 2014 for Switzerland and he spends 90 midnights in the UK in 14/15 tax year. He is a leaver not an arriver. He retains accommodation in the UK but he has a home in Switzerland at all times. He spends more time in Switzerland than any other country and his spouse lives there with him. His minor child is in boarding school and spends all the holidays with him. David has two ties in the UK—accommodation and the 90 day tie. Provided his family is non-UK resident, he does not work in the UK and he spends more time in Switzerland than the UK, he is not UK resident. He must limit his midnights to no more than 90 for 2014–15 and 2015–16. Thereafter he can increase his midnights to 120.

Note that David remains a leaver until April 6, 2017 even if he did not set foot in the UK during this period.

Example 7

Facts as in Example 6 above but David also has a work tie. He must limit his day count to 45 days in 2014/15 and 2015/16 rising to 90 in 2016/17. If he comes in and out of the UK on more than 30 occasions, excess days will be counted in those first two tax years. So if he comes to the UK on Monday and leaves on Tuesday, he can only do this 37 times before he exceeds his day count (37 midnights on Monday plus seven days of physical presence).

Example 8

Sarah is not UK resident on April 6, 2020 having lived in the Isle of Man for many years. She is therefore an arriver not a leaver. She has never spent more than 50 days in the UK each year in recent times. She has a house in the UK and wants to see more of her grandchildren. Her children are all adult and she has no spouse or cohabitee. She has one tie. She can spend up to 182 days in the UK without becoming UK resident. She will have one tie in 2020/21 (accommodation) and two ties thereafter (90 day tie and accommodation). She must then reduce her days in 2021/22 to 120 or less.

Example 9

Darley lives in the Middle East and is an arriver having not been UK resident for many years but his wife lives in London and the children are educated at London schools. He therefore has two ties – accommodation and family. He has spent less than 91 midnights in the UK in the previous two tax years. In 20/21 he can spend up to 120 days (midnights) in the UK as an arriver, but for the next two years he can only spend up to 90 days because he has three ties (90 days, accommodation and family) and is therefore limited to 90 days or less. (The 90 day tie applies if he has spent more than 90 midnights in the UK in either or both of the two previous tax years.)

Example 10

Elouise and her husband live abroad but own a UK flat. They can come here for up to 120 days (midnights) each year without becoming UK resident. They have two ties – 90 day and accommodation.

3. Domicile under common law

The following comments are intended to give only a brief outline of the elusive but important concept of domicile under English common law.[6] Domicile is not just relevant for tax but is also determinative for succession, family law and jurisdiction purposes. Over time the UK tax system has evolved a separate series of rules to 'deem' someone to be UK domiciled for tax purposes simply because they have been living here for a certain length of time. In short, long term residence is enough to make someone domiciled here for <u>tax</u> purposes. These deeming rules are discussed in Section 4 below.

The domicile under common law may be a domicile of origin, a domicile of choice or a domicile of dependence. A person cannot be without a domicile or have more than one domicile at a time. Everyone has a domicile of origin which is normally the father's domicile at date of birth, unless the parents are unmarried, in which case it may be the mother's domicile.[7] In England, with effect from 1 January 1976, an adopted child may acquire a new domicile of origin, being treated as born to the adopter(s).

A domicile of origin is retained until such person (not being a minor) acquires another domicile by choice which cannot occur until 16. However, if the person is under 16 and the parent's domicile changes (usually the relevant person is the father) the child acquires a domicile of dependency linked to that parent. That domicile of dependency becomes the child's domicile of choice automatically at 16 and remains unless and until the child leaves and does not intend to return.

An independent domicile of choice can only be acquired after 16 when a person fixes voluntarily his sole or chief residence in a particular place with an intention of continuing to reside there

[6] As to domicile generally, *see* Dicey, Morris and Collins (2018), *Conflict of Laws*, Sweet and Maxwell
[7] See *Henderson v Henderson* [1967]

permanently or for an unlimited time. Thus the acquisition of a domicile of choice involves the fact of residence as well as the intention to remain there permanently or indefinitely. The residence must be freely chosen and not prescribed by necessity, such as the duties of office, the demands of creditors, or relief from illness and must be general and indefinite in its future contemplation.

The domicile of origin will not be lost, even though a person may have no intention of living in the country of origin (and indeed may never have lived there), if he has not decided definitely in which of two or more other countries he will live. So the domicile of a person born in England of parents domiciled here is ipso facto English, but if, for example, on attaining his majority he elects to emigrate to Australia he will not lose his domicile of origin and acquire a domicile of choice until he settles in a particular Australian territory with an intention of living permanently or indefinitely in that state. If he afterwards decided to leave that state without intending to return, his domicile of origin would revive by operation of law and if he died before acquiring a new domicile of choice his domicile at death would accordingly be English. Thus the individual must not merely abandon his domicile of origin but replace it. The burden is on HMRC to show that a person with a foreign domicile of origin has acquired a UK domicile of choice.

The tendency of some decisions has been to emphasise the importance of the domicile of origin, and to attach less significance to residence, however long, as an indication of a change of domicile and the acquisition of a domicile of choice. Statements made by a person about his own domicile are by no means conclusive, whether made inter vivos or in a will. The courts adopt a cautious attitude to such statements, especially where the person had an interest in making such statements (e.g. to obtain fiscal advantages, or to deny jurisdiction in divorce proceedings).

The degree of 'permanence' required to establish a change of domicile and acquisition of a new domicile of choice was considered in *Re Fuld's Estate (No 3)*[8] by Scarman J. who said:

> *a domicile of choice is acquired when a man fixes voluntarily his sole or chief residence in a particular place with an intention of continuing to reside there for an unlimited time.*

This passage was approved by the Court of Appeal in *Buswell v IRC*[9] and *IRC v Bullock*,[10] where Buckley L.J. said at p.1185:

> *I do not think it is necessary to show that the intention to make a home in the new country is irrevocable or that the person whose intention is under consideration believes that for reasons of health or otherwise he will have no opportunity to change his mind. In my judgment the true test is whether he intends to make his home in the new country until the end of his days unless and until something happens to make him change his mind.*

In the *Bullock* case the taxpayer's domicile of origin was in Canada. His matrimonial home was in England and he lived here for over 40 years with his wife, but he intended to return to Canada if he survived his wife. He did not vote here, he read the Canadian newspapers and retained land in Canada. His wife was four years younger and had refused to move to Canada. The Court held that this contingent intention prevented him from acquiring an English domicile. In the words of Buckley L.J.:

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[8] [1968]
[9] [1974] 1 W.L.R. 1631.
[10] [1976] 1 W.L.R. 1178.

> *The question can perhaps be formulated in this way where the contingency is not itself of a doubtful or indefinite character: is there a sufficiently substantial possibility of the contingency happening to justify regarding the intention to return as a real determination to do so upon the contingency occurring rather than a vague hope or aspiration?*

These principles were applied with a different result in the estate duty case of *Re Furse, Furse v IRC*,[11] where an American citizen with a domicile of origin in Rhode Island had lived in Sussex for the last 39 years of his life, making annual visits to the United States. His intention was to return permanently to the United States when he became incapable of living an active physical life on his wife's farm in Sussex. It was held (understandably) that he died domiciled in England, because the contingency of returning was too vague and indefinite and permitted of almost infinite adjustment to meet his wishes. On the other hand, if it is a clearly foreseen and reasonably anticipated contingency, there may be no acquisition of a domicile of choice. Quite slight differences in facts can result in major differences in tax result.

In *Re Shaffer, Morgan v Cilento*[12] the issue was whether the playwright Anthony Shaffer, who died aged 75 in London on November 6, 2001, had abandoned a Queensland domicile of choice such that his English domicile of origin had revived. This was examined (in the context of the Inheritance (Provision for Family and Dependants) Act 1975). The judge held that he had established a domicile of choice in Queensland and his English domicile of origin had not revived before his death, i.e. he had not abandoned his foreign domicile of choice although it may have been 'withering'.

The *Shaffer* case can be contrasted with the unsuccessful attempt by the taxpayer in *Gaines-Cooper v RCC*[13] to abandon a UK domicile of origin and establish a domicile of choice in the Seychelles. Although Mr Gaines-Gooper had bought a house in the Seychelles, had expressed a wish that his ashes be scattered there, had stated in his wills that he lived and was domiciled there, and had married a Seychellois woman, the Special Commissioners nevertheless held that his ties to the United Kingdom, and particularly his retention of property in England and his other connections in the UK, indicated that he lacked the necessary intention to reside in the Seychelles indefinitely.

Non-tax cases confirm that a foreign domicile of origin cannot be maintained if there is no more than a vague assertion that you intend to leave the country where you have lived for many years. There must be some definite event on which you intend to leave such as retirement, the death of a spouse etc. Whether it is realistic in the real world for people to plan their lives in this way is very debateable and of course one of the reasons why domicile cases are so difficult. The recent non-tax cases on domicile seem more inclined to accept that a person who lives in the UK for any reasonable length of time can indeed acquire a domicile of choice here despite having a foreign domicile of origin. This is often because the cases concern whether the court has jurisdiction over a particular matter such as succession law or settlement of claims (where the court may be more inclined to intervene or assert jurisdiction).

In *Gulbenkian v Gulbenkian,*[14] the High Court held that the burden of proof to supersede a domicile of origin by a domicile of choice had been discharged. The issue was whether a husband was domiciled in England for divorce purposes. His father was an Armenian by birth and subject to the Ottoman Empire and the husband had lived in England from the age of three months with

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[11] [1980] STC 596
[12] [2004] EWHC 188 (Ch)
[13] [2007] EWHC 2617 (Ch)
[14] *618 4 All ER 1937*

his father. The husband received an English education at Harrow and at Cambridge with an interlude at the University of Bonn in his gap year. His father meanwhile alternated between London and Paris and eventually moved to Paris. The husband tried to argue that he had never had any intention of making his permanent home anywhere and was really dependent on what his father decided to do. He therefore had not lost his foreign domicile of origin and had not acquired a UK domicile of choice. The judge suggested he had never formed any intention of making a permanent home yet because he had never been confronted with any necessity to crystallise his general views upon the matter into a set and fixed decision. However: 'I have no doubt in my own mind that he has an overwhelming preference for England and unless he was confronted with the certainty that by so doing he would lose his inheritance from his father he would declare for an English domicile'. It was held that the intention to live in the particular country must not necessarily be irrevocable even if unlimited in period. A domicile of choice can be inferred even if the individual has not taken any deliberate decision at any given or particular moment.

A negative intention in the form of an absence of an intention either to return and settle in the country of origin has being held sufficient to enable a person to acquire a domicile of choice in the country in which he is currently resident and lose his domicile of origin. See *Steiner v CIR*.[15] An individual(s) born in 1889 in what is now Czechoslovakia but was then part of the Austrian Empire moved to Berlin in 1906 and established a textile business there. He came to England in 1939 to escape Nazi persecution and in 1947 successfully applied for British nationality. It was held by the Special Commissioners that he had acquired an English domicile of choice in the 1950s, despite the fact that he spent about six months in each year in Berlin prior to his death, he did not speak good English and had acquired a flat in Berlin.

A domicile of choice, unlike a domicile of origin, can be abandoned without acquiring any new domicile; but it is still necessary to show both a change of residence and a change of intention. In *IRC v Duchess of Portland*,[16] Nourse J said that the law is stated 'with accuracy and concision' by Dicey's rule 13(1), namely:

> *A person abandons a domicile of choice in a country by ceasing to reside there <u>and</u> by ceasing to intend to reside there permanently or indefinitely, and not otherwise.*

It appears therefore that where a person loses mental capacity, having acquired a domicile of choice abroad, even if he becomes resident in England he will not lose his domicile of choice because he did not have the necessary intention to cease residing in the country of that domicile. If the lack of capacity dates from birth or from a time when he was a dependant child, his domicile will remain that of his dependency.

In *Allen v RCC*,[17] the Special Commissioner decided that an elderly deceased woman did not lose her domicile of choice in Spain (despite her United Kingdom domicile of origin and the fact that she had lived with relatives in the United Kingdom in the last few years of life and even acquired a home in the United Kingdom) because she maintained a foreign home ready at all times for her occupation and it was clear that she would have returned to Spain if she could have persuaded relatives to look after her there. Retention of a house in the country of choice is evidence of intention to return, but is not a condition of retaining a domicile of choice once acquired

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[15] [1973] STC 54. See also *Boldrini v Boldrini Court of Appeal* [1932] P 9. Here a waiter of Italian nationality was registered as an alien in England. It was held that he had acquired an English domicile of choice despite the fact that the authorities could deport him. He had no intention of living anywhere else.
[16] [1982] STC 149
[17] [2005] S.T.C. (SCD)

although it is hard to see how a domicile of choice can be acquired in the first place without such a residence.

It has been held by the House of Lords that a person in the United Kingdom illegally may become domiciled here. While the illegality of the residence is a factor in deciding whether such a person has a genuine intention to remain in the United Kingdom, nevertheless the illegality will not in itself mean they cannot acquire a United Kingdom domicile of choice here.[18]

In *Holliday v Musa*,[19] the Court of Appeal held that a Cypriot had abandoned his domicile of origin and acquired a domicile of choice in England. It confirmed that the correct test to apply is not whether the relevant person intended to return to his country where he had a domicile of origin, but rather whether he intended to settle permanently in the particular jurisdiction where domicile is claimed. Contrast *Cyganik v Agulian*[20] and *Ramsay v Liverpool Royal Infirmary & Others*[21] where despite very lengthy periods of residence in England by both persons, the deceased in each case was held not to have lost their respective Cypriot and Scottish domiciles of origin. The more recent case of *Proles v Kohli*[22] suggests the Court may take a sceptical line on those who argue they have not acquired an English domicile of choice after living here for some years. The deceased was an Indian who had come to the UK in his late 40s and set up a restaurant business and acquired property here. He was held to have acquired a UK domicile of choice after less than 15 years' residence.

Example 11

Peter was born in California where his father, an Englishman had emigrated shortly before his birth. His father then moved the family to New York State and later retired to Florida when Peter was 18. At the date of Peter's birth it is likely that Peter had an English domicile of origin despite never having lived here as the father does not seem to be settled in any particular US state. The fact that his father does not intend to return to the UK does not mean he has acquired a foreign domicile of choice and lost his UK domicile of origin. During Peter's minority his father remains unsettled until retirement. Peter may therefore have an English domicile of origin that remains his domicile until he reaches 16. At that point the question is whether he acquires a domicile of choice: i.e. has he resolved to settle in a particular US state?

Obtaining a Domicile Ruling

HMRC will not give a ruling on a person's domicile unless it is relevant to the determination of a current tax liability. Their practice until August 2010 for income tax and CGT purposes was set out in Tax Bulletin 29. If the individual had not yet submitted a tax return, HMRC would continue to give a written ruling for that tax year if a DOM1 form or P86 was submitted before the return was due. That practice has now stopped. Otherwise the individual had to self-assess by ticking the boxes on the non-residence pages of a return; claiming foreign domiciled status and HMRC might then choose to investigate as part of an enquiry.

An alternative strategy, particularly if the person had been UK-resident for some years but was not yet deemed domiciled (for IHT purposes) and wanted a ruling quickly, was for him to settle foreign situate property of (say) £350,000 (i.e. more than his nil rate band) into trust. The trust was then reported to HMRC requesting confirmation that the person was not UK-domiciled. If he was considered not UK-domiciled no IHT was due, otherwise the transfer was chargeable. HMRC generally gave a ruling if the tax at stake was over £10,000. On 24 August 2010 HMRC

[18] See *Mark v Mark* [2006] 1 A.C. 98.
[19] 2010] EWCA Civ 335.
[20] [2006] 8 ITELR 762
[21] House of Lords (1930)
[22] [2018] EWHC 767(Ch)

issued Brief 34/10[23] stating that no domicile rulings would be given for IHT purposes unless there was a 'significant risk of loss' of tax and that the taxpayer should expect a forensic examination of his life. In practice HMRC now rarely give a favourable domicile ruling when someone has settled property into trust even if the amounts involved are significant. Tax practitioners have complained of an increasing number of enquiries into taxpayers' claims to foreign domicile, enquiries under self-assessment are often very long drawn out and unsatisfactory for both sides. HMRC are often keen to interview taxpayers who have been living here for many years and claim they retain a foreign domicile.

Any domicile ruling is relevant and valid only for the year in which it is given but if the person's personal circumstances do not change it is unlikely that HMRC will take a different view in later years. See Brief 17/09 where HMRC[24] note:

> *where HMRC has expressed an opinion on the domicile status of a settlor for inheritance tax purposes we will not normally seek to reconsider that opinion unless new information becomes available that indicates our initial opinion was incorrect or there has been a material change in the circumstances of the settlor. However, when we make a decision it applies only to the date of the transaction concerned. So if circumstances change, the individual returns to the UK for example, that individual's domicile may need to be considered again at another point in time.*

Of course, continued residence in the UK beyond what was originally anticipated can in itself be evidence of change of intention and a relevant circumstance which might give rise to a different domicile ruling.[25]

In the absence of any ruling the usual enquiry system applies. At RDRM 23080 HMRC note:

> *Enquiries into domicile status: Schedule of useful information and documents*
>
> *The list below shows the types of information that might be requested during an enquiry. It should not be regarded as either prescriptive or comprehensive, and the individual may offer other relevant information or evidence for consideration too ... Any information request should be tailored to the particulars of the individual's claim, and their present circumstances. It is always important to think about the relevance of particular items of information to the detailed subject matter of each enquiry. An information request need not be limited only to the items listed here, nor will all items*

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[23] https://webarchive.nationalarchives.gov.uk/20130102215405/http://www.hmrc.gov.uk/thelibrary/briefs2010.htm

[24] ibid

[25] See *Gulliver v HMRC* [2017] UKFTT 222(TC). the taxpayer (who was chief executive of HSBC with a UK domicile of origin) argued that he had obtained a foreign domicile in 1999 while living in Hong Kong. In 2002 (while back in the UK on a short-term assignment that in fact continued for some years) he settled slightly over the nil rate band of cash into a trust and sent in an inheritance tax return. In fact, HMRC did not formally confirm his foreign domicile but simply accepted by letter there was no transfer of value and so no inheritance tax payable. Over ten years later (when still in the UK), HMRC issued an enquiry into his income tax return for tax year 2013/14 raising over 100 questions going back to his life in the 1980s. The taxpayer applied for a closure notice on the basis that HMRC were bound by their letter to accept that he had acquired a Hong Kong domicile of choice in 1999 and that they could not raise any enquiries now that related to the acquisition of this foreign domicile in 1999. The taxpayer argued that HMRC enquiries must be confined to seeking to establish whether he had lost his Hong Kong domicile of choice not whether he had acquired it in the first place. The Tribunal rejected this, holding that HMRC were not prevented by the 1999 letter (or even a court decision in 1999) from arguing in later years (where relevant to his tax position) that Mr Gulliver had never acquired a UK domicile of choice. The domicile ruling could only be relevant to the tax liability for the year in question.

listed necessarily be appropriate in all cases. It may not be possible for some individuals to provide some of the items on the list, even if they would be useful to an understanding of their domicile status. Given the inevitable passage of time in many cases, HMRC and the individual may need to consider how best the facts can be checked and tested.

Information

- *Date of birth.*
- *Parents' full names, including mother's maiden name, and places of birth.*
- *Background to the place of birth, if this was not in the same territory as the parental home at the time.*
- *Details of any name changes, and where, if at all, such changes were registered.*
- *Nationality (citizenship) at birth, including an explanation of its basis where this is not obvious from the context.*
- *Details of any changes in or additions to the nationality (citizenship) at birth, with explanations of the relevant background.*
- *Information about any adoption proceedings.*
- *If parents were not living together at any time during the period of derived domicile, an explanation of the background to this matter and how parental responsibilities were exercised.*
- *Information about relationships entered into by parents following their separation during the period of derived domicile.*
- *Details of siblings.*
- *List of places of residence from birth to the time of the enquiry, including home addresses.*
- *An explanation of the reason for residence at each place on the list.*
- *Details of legal rights of residence in respect of each place and a summary of any visas, permits or other official documents required.*
- *Summary of educational background, including places of education, periods of attendance and qualifications obtained.*
- *Details of military service.*
- *Details of governmental or diplomatic service.*
- *Summary of employment and/or business history.*
- *Explanation of employment and/or business plans, including anticipated retirement, and any arrangements that are in place in respect of these matters.*

- *A detailed summary of properties that have been available for use other than as short-term holiday lettings. This should include the addresses of all the properties, a description of them, details of their ownership, the periods during which the properties have been available, and an explanation of how they have been used when not occupied by the individual.*

- *Details of all marriages, civil partnerships, separations and divorces, including information relating to other relationships involving long-term cohabitation. These should cover the full names of any relevant parties, their dates, places of birth and nationalities, the periods during which the relationships existed, the dates of any formal acts or ceremonies, information relating to the domicile of the other parties, and explanations of any periods during which the parties to the relationship did not live together.*

- *Information about transfers of property, including those between spouses or civil partners.*

- *A summary of the names, dates of birth and nationalities of the children of the individual.*

- *Details of where any children were or are being educated.*

- *Information relating to the exercise of political rights in any territory, as either a voter or a representative.*

- *Membership of any political parties, or participation in campaigns or lobbying groups, and the extent of any activities.*

- *Details of professional qualifications, membership of professional bodies and active participation in these, including offices held.*

- *Summary of membership of clubs, societies, associations, organisations and other bodies, and details of the level of participation in these.*

- *Information about any representative activities undertaken on behalf of a country, territory, or any political, territorial or other sub-division thereof.*

- *The location of personal papers and any items of financial, sentimental or other value. If such items are moveable, the place where they are usually kept and details of any insurance policies in respect of them.*

- *Summary of any deeds, declarations, covenants and similar documents created, including those relating to dependants. Information relating to any legal proceedings or other matters in which domicile was relevant, either as a basis for any action or as an evidential point.*

- *Locations of members of the extended family, including a description of the relationship between the individuals.*

- *Details of religious, cultural and social connections, including the degree of religious observation, the level of participation in social and cultural life, and ability to speak, read and write relevant languages.*

- *Information about charitable and voluntary activities, including the foundation of charitable trusts, donations to charities and good causes, and active participation in the administration or fund-raising activities of third-sector organisations.*

- *Summary of professional and personal advisers, including their locations and details of the nature and extent of the services that they provide.*

- *An explanation of the individual's intentions for the future. What plans have been made? What contingencies have been taken into account? What would cause a change of residence? What provision has been made for the future? What has the individual actually done that provides evidence for the answers to these questions?*

- *A summary of any connections not specifically mentioned above that the individual has with various territories. When did these begin and precisely what form have they taken over the years? How much time has the individual spent in each territory during the relevant period? What was the reason for such presence?*

This is a fairly daunting list for both HMRC and the individual. It demonstrates the difficulty in determining domicile. For tax purposes it is surely unsatisfactory that the position can be so hard to determine. Is it sensible to use domicile as a connecting factor at all in any tax context?

4. Deemed domicile for tax purposes[26]

4.1 The position before April 2017

Prior to April 2017 the IHT legislation already contained statutory provisions deeming someone to be domiciled here if they had been UK resident for more than a specified number of tax years and these have now been tightened and extended for all tax purposes from April 2017.

The broad effect of IHTA s.267 and s.267ZA in its old form was that there were three separate deeming rules. The first two were found in s.267. The third is found in s.267ZA and allows a foreign domiciliary to elect to be deemed domiciled in the UK for IHT purposes only in order to benefit from spouse exemption if the UK domiciled spouse/civil partner has died leaving everything to that spouse.

Under s.267(1), a person not domiciled in the United Kingdom at any time (the 'relevant time') was to be treated for inheritance tax purposes as domiciled in the United Kingdom (and not elsewhere) at the relevant time if:

(a) he was domiciled (as a matter of common law) in the United Kingdom within the three years immediately preceding the relevant time; [that rule remains in place] or

[26] Domicile of politicians and members of the House of Lords. For completeness I should add that the Constitutional Reform and Governance Act 2010 s.41 provides special rules for residence and domicile of MPs and sitting members of the House of Lords. From 2010–11, they have been deemed resident and domiciled in the UK for all tax purposes whatever their actual status. Of course this does not prevent such persons still benefiting from the excluded property regime if they settled assets into trust before they became an MP or member of the House of Lords and while foreign domiciled (and provided that they are not a formerly domiciled resident – see below). The settled property continues to be protected from inheritance tax.

(b) he was resident in the United Kingdom in not less than 17 of the 20 years of assessment ending with the year of assessment in which the relevant time falls (that rule has been replaced as set out below).

Example 12 – illustrating head A

A is domiciled in some part of the United Kingdom under common law. In October 2002 he goes abroad and five years later in say July 2007 acquires a foreign domicile having resolved to settle in a particular country. Under limb (*a*) he is treated as having a United Kingdom domicile for the next three years, i.e. until July 2010. Only then can he lose UK domicile for IHT purposes.

4.2 Deemed domicile from April 2017

In July 2015 the government announced a fundamental change to the way in which foreign doms would be taxed. The key point was the proposed introduction of a concept of deemed domicile for all UK tax purposes no longer limited only to IHT for anybody 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. The proposals were eventually enacted in F(No2)A 2017 and took effect from April 2017.

However, in an attempt to ensure that long-term non-domiciliaries remained in the UK after becoming deemed domiciled, it was proposed that overseas assets held in a trust would be outside the scope of UK tax except to the extent of benefits received from the trust. These 'trust protections' for income tax and CGT purposes were enacted in F(No 2)A 2017 Schedule 8 and are not discussed further here.

Two new categories of deemed domiciliary are created with effect from 6 April 2017 for all tax purposes:[27]

(c) UK resident individuals who were born in the UK with a UK domicile of origin (a formerly domiciled resident or 'FDR'). Although such an individual may have an actual domicile outside the UK, none of the benefits normally conferred on a non-domiciliary are available to a formerly domiciled resident.

(d) Individuals who have been resident in the UK for at least 15 years out of the previous 20 tax years. This replaces the 17 year rule in 4.3(b) above. The effect of this for an individual who has lived in the UK for 15 out of the last 20 years is that they will become deemed domiciled in the UK at the start of year 16 even if they are no longer UK resident in that tax year. In order to avoid deemed domicile in year 16, they would need to leave the UK in year 14 and make sure that they are not UK resident in year 15.

It was recognised that a formerly domiciled resident may become UK resident for a brief period due to circumstances beyond their control, such as the illness of a close relative in the UK or a brief secondment to the UK as part of their work. In response to concerns, it was accepted that a formerly domiciled resident should not become subject to inheritance tax on a worldwide basis until their second year of residence.

As noted above, under the pre-April 2017 regime, an individual would be deemed domiciled for IHT purposes if he or she had been UK resident for 17 years out of the 20 year period ending with the year of assessment in question. The result of this was that an individual who became non-resident would lose their deemed domicile at the beginning of their fourth year of non-residence. Under the new rules an individual who is domiciled abroad under common law ceases to be deemed domiciled for IHT purposes at the beginning of their fourth year of non-residence

[27] s835BA ITA 2007; s267 IHTA 1984

(assuming they remain non-UK resident for six tax years).[28] If the individual were to return to the UK in the fifth or the sixth year after leaving, they would again become deemed domiciled under the 15 out of 20 year test.

For inheritance tax purposes, one benefit of setting up a trust whilst non-domiciled is that the non-UK assets in the trust will remain outside the scope of UK inheritance tax even after the settlor becomes deemed domiciled in the UK. This continues to be the case for individuals who become deemed domiciled as a result of having been UK resident for 15 years. However, this treatment is withdrawn in the case of formerly domiciled residents so that overseas assets in trusts established by such individuals whilst non-domiciled will come within the scope of UK inheritance tax once the individual is in the second year of UK residence.[29]

Example 13 - FDRs

John was born in the UK and had a UK domicile of origin. He left the UK when six months old and has lived in Belgium all his life. He has acquired a Belgian domicile. He sets up a foundation for the benefit of himself and his family which is classified as a trust for IHT purposes. In April 2017 he is then posted to the UK for a short-term work assignment. From year two he will be IHT deemed domiciled here for all tax purposes (year one for income tax and CGT) and cannot claim any favourable IHT treatment. His foundation will not have excluded property status while he is UK resident. Thus if he dies here the foundation will be subject to tax on his death under the reservation of benefit rules. If the foundation's ten-year anniversary falls while he is UK resident then IHT is payable. Any capital distributions will be subject to an exit charge. Once John leaves the UK the foundation can revert to excluded property status.

John has a brother who was not born in the UK although also has a UK domicile of origin. John's brother has also never lived here and has a Belgian domicile of choice. His brother is not a formerly domiciled resident. His brother can come and live in the UK and provided he retains his Belgian domicile of choice will remain foreign domiciled for UK tax purposes for the next 15 years.

Example 14

It is curious that John, who actually retains a foreign domicile by law is subject to an unfavourable tax regime by an accident of birth. Contrast the position with Angelo who is foreign domiciled by origin and set up his trusts some years ago before arriving in the UK. He has been living in the UK for 30 years and accepts he has now acquired a UK domicile of choice. He is certainly deemed domiciled here for all UK tax purposes. His trusts remain excluded property for IHT purposes!

[28] s267(1)(b)(ii) IHTA 1984
[29] s48(3E) IHTA 1984