Non-domiciliaries
Trust protections

Background

The Government recognises that limiting tax benefits for non-domiciliaries to 15 years could result in many of those affected by the deemed domicile provisions leaving the UK if they would otherwise be subject to tax on all of their assets on a worldwide basis.

As a result of this, protection from UK tax is available for assets transferred into trust prior to becoming deemed domiciled.

To try and minimise the number of different tax regimes for offshore trusts, a key part of the changes to the taxation of income from offshore structures applies to all trusts established by non-domiciliaries and not just those where the settlor is deemed domiciled in the UK.

As a result of the perceived generosity of the trust protections, the Government has taken the opportunity to tighten up the anti-avoidance provisions which apply to offshore trusts. Again, some of these changes apply to all trusts and not just those affecting deemed domiciliaries. These anti-avoidance provisions are explained in more detail in our note: Offshore Trusts – Enhanced Anti-Avoidance Rules.

The pre-6 April 2017 tax regime for offshore trusts

In order to understand the trust protections, it is worth briefly reviewing how the rules worked prior to 6 April 2017.

Capital gains tax

A settlor who was UK resident and domiciled would normally pay tax on trust gains as they arose. This included gains on assets held in underlying companies unless (as was often the case) it could be shown that the company was not set up to avoid capital gains tax.

On the other hand, if the settlor was not UK domiciled (or was not UK resident), the trust gains were attributed to beneficiaries who received benefits from the trust. Any beneficiaries who were UK resident would pay tax unless they were non-domiciliaries who paid tax on the remittance basis, in which case they would only pay tax if the benefit was remitted to the UK.

Income tax

A UK resident settlor was taxable on the income of a trust structure if the settlor or the settlor's spouse could benefit from the trust. There were two overlapping regimes:

- The transfer of assets abroad regime – this applied to income both at a trust level and income of an underlying company owned by the trustees. It did not apply if it could be shown that UK tax avoidance was not one of the reasons for setting up the trust or of any subsequent transaction related to the trust or its assets.
- The settlements code – this only applied to trust level income (and not the income of underlying companies) but there is no motive defence.

In both cases, the remittance basis was available in respect of non-UK income. UK source income was taxed as it arises.

If the settlor was not taxed on the trust income (either because the settlor and the settlor's spouse were not beneficiaries or because the settlor paid tax on the remittance basis and the income was not UK source income and was not remitted to the UK), the untaxed income was attributed to any UK resident beneficiary who received a benefit from the trust. This benefits regime is part of the transfer of assets abroad rules and so is subject to the motive defence.

Beneficiaries who pay tax on the remittance basis were only taxable on the benefit if:

- the benefit was matched against UK source income;
- the benefit was remitted to the UK; or
- the overseas income, which was matched against the benefit, was remitted to the UK by the trustees (or the underlying company).

In the normal case of a non-domiciled settlor who had set up a discretionary trust of which the settlor was a beneficiary, the effect of these rules, where the settlor becomes deemed domiciled in the UK would, without more, be that the settlor is immediately:

- taxable on all of the income and gains of the trust; and
- subject to the capital gains tax / transfer assets abroad motive defences, also on the income and gains of underlying companies owned by the trust.

Trust protections

The trust protections protect deemed domiciled settlors from an immediate tax charge on income and gains of a trust established before becoming deemed domiciled other than in the case of UK source income, which remains taxable.

Non-UK assets in such a trust are also outside the scope of UK inheritance tax.

These sorts of trusts are therefore very beneficial for deemed domiciliaries.

As mentioned above, the changes needed to deliver the income tax trust protections apply to non-domiciled settlors of offshore trusts even where the settlor has not become deemed domiciled in the UK. This may have significant implications for how the trust is managed and how the trust funds can be invested in the future, as explained further below.

The new regime has been in place since 6 April 2017.

Capital gains tax

Although, for most purposes, a deemed domiciled individual is taxed in exactly the same way as an individual who is UK domiciled, this is modified in relation to the capital gains tax rules for offshore trusts.

As described above, if a settlor is resident and domiciled in the UK, trust gains are immediately taxed on the settlor. This is not the case if the settlor is deemed domiciled in the UK but has not actually become UK domiciled under general law.

The one exception to this is settlors who are deemed domiciled as a result of being born in the UK with a UK domicile of origin (a formerly domiciled resident) who do not get any of the benefits or reliefs available to individuals who become deemed domiciled in the UK solely as a result of having lived here for more than 15 years. References to deemed domiciled settlors in the rest of this note are to such individuals and not to formerly domiciled residents.

The offshore trust capital gains tax regime therefore remains exactly the same for deemed domiciled settlors as it was before becoming deemed domiciled, subject to the additional anti-avoidance provisions mentioned above.

The result of this is that tax is only payable when the deemed domiciled settlor (or another UK resident beneficiary) receives a benefit from the trust which can be matched against trust gains. As the settlor is deemed domiciled in the UK, tax will be payable on any attributed gains whether or not the benefit is received in the UK.

Tainting a protected trust

This protection from the capital gains tax settlor charge ceases to apply if any addition is made to the trust by the settlor or by any associated trust (another trust established by the settlor or of which the settlor is a beneficiary) after the settlor has become deemed domiciled in the UK.

Given the catastrophic consequences of even a small addition to a trust (the trust protections are lost in their entirety), great care needs to be taken to avoid any inadvertent addition to the trust.

This is an area which trustees will need to pay very close attention to in the future.

What constitutes an addition is widely defined and includes for example:

- adding value to property held by the trustees; and
- a loan from the settlor to the trustees unless the trustees actually pay interest on the loan at least annually and the interest rate is not less than HMRC's "official" rate of interest (currently 2.5 per cent).

Fortunately there are some helpful exceptions in the legislation:

- in the case of a loan, an inadvertent addition will not taint the trust if there was no intention to confer a gratuitous benefit; and
- cash can be added to a trust to pay trust expenses if the expenses exceed the available trust income or, even if there is surplus income available, if the expenses are properly payable out of capital rather than income. Cash cannot however be added to pay the expenses of a company owned by the trust as opposed to the expenses of the trust itself.

HMRC have also provided some useful clarification on a couple of points:

- they will not treat the failure by a settlor to exercise a power of revocation as an addition. No comment has been made in relation to other trust powers retained by the settlor but there is no reason to think that the same principles should not apply; and
- HMRC have confirmed that, in the case of a life interest trust, failure by the trustees to require a company which they own to pay a dividend (and so depriving the life tenant of income) will not constitute an addition by the life tenant (which would be a problem if the life tenant was the settlor).

Tainting and loans
Loans can cause particular problems when it comes to tainting given the difficulty of knowing whether a loan is on arm's length terms. The legislation is therefore helpful in specifying what is to be treated as arm's length in these circumstances.

Where a loan is made to a trust, the loan will be treated as being on arm's length terms if the trustees have to pay interest at a rate which is no less than the "official rate" (currently 2.5 per cent) at least annually. It is not enough that the loan agreement specifies that interest must be paid annually. The terms of the loan agreement must be adhered to and the interest must not be capitalised.

If a loan is made by the trustees to the settlor, the interest charged must be no more than the official rate of interest (but could be less) and there is no requirement that the interest must be paid annually. If the interest rate is less than the official rate or the interest is not paid annually, the settlor will be in receipt of a taxable benefit.

If the settlor has made a loan to the trust which is not on arm's length terms (as defined above) and which is repayable on demand, the legislation specifically provides that the trust will be tainted (and will therefore lose the trust protections) on the day the settlor becomes deemed domiciled. Fixed term loans are not a problem as long as they are repaid at the end of the fixed term (or put on to commercial terms).

The statutory arm's length definition only applies to loans made by or to a trust. It is not clear whether the same rules apply to a loan made by or to a company which is owned by a trust. Until we receive clarification on this (and further guidance on all of the changes is expected later this year), the safest course is to assume that the same rules apply.

Tainting – adjustment agreements
One way of making sure that a transaction between a trust and the settlor (or an associated trust) will not taint the trust is to enter into an adjustment agreement. This is an agreement which provides that, if there would otherwise be a tainting, there is either an adjustment to the terms of the transaction or a payment (with interest) by the trustees in order to reverse the addition.

Although, for transactions other than loans, there will be no tainting in any event if there is no gratuitous intent, the existence of an adjustment agreement will demonstrate that there was no such intent.

As far as loans are concerned, an adjustment agreement will be important where a loan is made by or to a company owned by the trustees rather than to the trustees themselves given the lack of clarity over whether statutory arms-length rules apply in these circumstances.

Income tax
The rules for taxing non-UK source income of offshore trusts have been changed for all trusts with non-domiciled settlors and not just those where the settlor becomes deemed domiciled in the UK as a result of having lived here for more than 15 years.

Foreign income of the trust structure is no longer treated automatically as the settlor's income. Instead, it will only be taxed if the settlor receives a distribution and that distribution can be matched against the pool of accumulated income in the trust.

One exception to this is where the settlor can benefit from the income of a company owned by the trust otherwise than as a result of being a beneficiary of the trust. This might be the case, for example, if the settlor personally owns some shares in the company. In such circumstances, the income of the company is likely still to be attributed directly to the settlor.

In addition, due to the way the legislation is drafted, it appears that profits on the disposal of an interest in a "non-reporting" status offshore fund (offshore income gains – which are taxed as income) are not protected where the settlor is deemed domiciled in the UK and so an immediate tax charge will arise. It is hoped that a retrospective amendment will be made to rectify this but with pressure on the parliamentary timetable due to Brexit this cannot be guaranteed. These sorts of investments should therefore be avoided where the trust is protected and the settlor is deemed domiciled.

UK source income will continue to be taxed on the settlor as it arises.

Foreign income which has arisen prior to 6 April 2017 and which has been retained in the structure will form part of the pool of income which can be matched against future benefits.

It is clear that benefits received by a settlor before 6 April 2017 and which have not previously been taxed will not be brought into account for matching purposes as far as income retained in the structure is concerned (although any unmatched benefits can still be matched against future capital gains and so having significant unmatched capital payments where the settlor is likely to become deemed domiciled in the UK is generally not advisable).

Any income which has previously been treated as the settlor's income but which has been retained in the structure will no longer be taxed on the settlor if it is remitted to the UK by the trustees. In principle, this means that the trustees could use such income (and any future income) to invest in the UK.

The remittance of the income to the UK could have however have future UK tax consequences if there are beneficiaries of the trust who are resident but not domiciled in the UK and who pay tax on the remittance basis.

If the trustees confer a benefit on such a beneficiary outside the UK, the benefit will be matched against the untaxed income in the trust under the transfer of assets abroad rules unless the motive defence applies. Even if the benefit is not remitted to the UK, if it is matched against the income which the trustees have remitted to the UK, the beneficiary will still face an immediate UK tax charge.

The result of this is that trustees are unlikely to remit income to the UK if there is any possibility that they may wish to confer non-UK benefits on remittance basis taxpayers at some point in the future.

There is also a difference between the way in which the remittance rules work in relation to pre-6 April 2017 income under the transfer of assets abroad rules (which apply to all income in the structure) and the settlements code (which only applies to trust level income).

For example, if the trustees use trust income which arose before 6 April 2017 to purchase a property which the settlor lives in, paying a market rent, this would be a taxable remittance of the income which is used to purchase the property.

On the other hand, if a company owned by the trustees used income received by that company to purchase the property, there would be no taxable remittance.

It is difficult to see the logic for this difference in approach. However, the good news is that income which arises after 5 April 2017 either at trust or company level can be used to purchase assets for the use or enjoyment of the settlor without a taxable remittance arising.

The possibility of a future tax charge on a remittance basis beneficiary who receives a non-UK benefit as described above must however still be borne in mind. Use of the income in the UK may therefore only be feasible if all the beneficiaries are UK domiciled or deemed domiciled.

This change in treatment of trust income does raise the question as to whether there remains any point in keeping capital and income separate within a trust structure established by a non-domiciled settlor. Clearly, it will simplify the administration of the trust and the management of any investment portfolio if income and capital can be mixed.

Going forward, one benefit in keeping income separate is that income which has arisen over a number of years could be distributed to a non-UK beneficiary if it has been kept separate whereas this would not be possible if the income and the capital have been mixed.

It may also be important to keep income separate so that the trustees can identify whether the income has been remitted to the UK if there is the possibility of non-UK benefits being conferred on remittance basis taxpayers in the future given the scope for such remittances to create immediate tax liabilities as described above.

Tainting

As with capital gains tax, the income tax trust protections are lost if an addition is made to the trust at a time when the settlor is deemed domiciled in the UK. The result of this is that the old rules apply and the settlor pays tax on all of the trust income (and, subject to the motive defence, the income of any underlying companies) as it arises.

The tainting rules are exactly the same as for capital gains tax, described above.

Practical implications

Many clients will have taken action before 6 April 2017 in anticipation of the proposed changes. This includes not only individuals who will have become deemed domiciled on 6 April 2017 but also non-domiciled settlors of offshore trusts who are affected by the changes to the income tax treatment of offshore trusts.

The changes to the income tax treatment of offshore trusts is very significant indeed as it potentially allows income of the trust structure to be used in the UK as long as it is not distributed.

In addition, it may mean that income no longer needs to be kept separate which will not only be a welcome simplification but will also significantly extend the range of acceptable investments for any portfolios held within the trust structure.

There will be no “one size fits all” solution to trusts affected by these changes and specific, timely advice should always be obtained.

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