Weighing it up

Inheritance tax and trusts | Personal tax

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Stephen Arthur explains the requirements and benefits of offshore trusts, and how to determine if a UK tax liability arises

Key Points

What is the issue?

When considering whether your clients should use offshore trusts, you should think about whether the additional costs of offshore trusts outweigh the benefits, and whether they will be exposed to unwanted publicity.

What does it mean for me?

Offshore trusts can provide a tax efficient estate planning structure for many clients, not just the ‘super-rich’. Long-term cross-generational tax benefits in substantial CGT and income tax savings justify additional professional costs. ‘Panama papers’ and similar public domain information are unlikely to create problems.

What can I take away?

An understanding of the issues surrounding offshore trusts, and how to use them to manage timing and levels of UK tax liabilities within a family.

Before addressing taxation issues, timing requires some mention of the so-called ‘Panama papers’. Trusts remain largely unaffected by press prurience into the Mossack Fonseca company files which have come into the public domain. Although most offshore trusts, for a variety of reasons, usually own all the issued shares in an underlying holding company (often provided by corporate formation service providers, such as the source of the ‘Panama papers’) there is little or no information in those papers regarding ‘ultimate beneficial ownership’ where trustees are shareholders. The author’s personal experience is that corporate formation providers have historically seldom asked for those details when providing shelf companies to other professionals or to corporate and trustee service providers.

A greater threat to privacy and the anonymity provided by offshore trust structures is the Small Business Enterprise and Employment Act 2016 which came into effect on 5 April 2016. That Act requires all UK companies to maintain a public register of ‘persons with a significant interest’ – i.e. 25%+ shareholding, or voting powers, or (regardless of formal legal rights) individuals whose views are taken into account by company directors before deciding company policy and strategy. In the context of a discretionary trust which owns, directly or indirectly, more than 25% of any UK company, ultimate beneficial ownership cannot easily be defined – but any person who has the power to remove or appoint trustees (whether professional protector or nominated family member, or perhaps the settlor during lifetime) will be regarded as a ‘person with a significant interest’ and must be named on the public UK register.

There are inheritance tax (IHT) benefits of offshore trusts, but they require a non-domiciled settlor in order to have the opportunity to ensure that trust assets are always ‘excluded property’ and therefore outside the scope of IHT liability.

The basic rule is that offshore trusts can operate like a tax-free pension fund. The two requirements to achieve that are:

- a deceased or non-UK resident settlor. TCGA 1992 s 86 treats trust gains as being the settlor’s personal gains if members of the settlors family, down to grandchildren, can benefit and if the settlor is UK resident; and
- no direct UK investments by trustees. FA 2013 imposed UK income tax liability at the 45% rate applicable to trusts (RAT) on UK source investments income. UK investments can be made through an underlying non-UK investment holding company.

If those two tests are satisfied, there is no UK tax liability unless a UK resident receives a physical payment of money or transfer of assets from a non-resident trust, or otherwise receives any benefit from the trust for which the individual pays less than arm’s-length value. This would include rent-free occupation of a property or an interest-free loan.

If any UK resident individual who has transferred assets directly or indirectly into a trust structure might be able to take some benefit from the trust at any time, all trust structure income will be treated as the personal annual income of that individual on an arising basis under ITA 2007 s 720. For an example of how wide-reaching this section is in practice, see *CIR v Botnar CA* [1999] STC 711.

How does UK tax liability arise?

Leaving aside ITA 2007 s 720, in order to determine whether any tax is payable analysis is required of historic:

- income received by the trust structure (the trust and any underlying companies). This income is now referred to as 'relevant income' in ITA 2007 s 733; and
- 'offshore income gains' (OIGs) comprised within realised trust gains. The reference here is the Offshore Funds (Tax) Regulations 2009 (SI 2009/3001), in particular regs 20 and 21. OIGs are usually realised from investment in offshore collective investment funds that are not registered with HMRC in the UK – typically a private bank internal client investment fund; and
- gains realised by or within the trust structure – that is the trust and any underlying companies. Practitioners refer to undistributed gains as 'stockpiled gains'. Bear in mind this is not a statutory term since the legislation refers to 'TCGA 1992 s 2(2) amounts'. However, practitioners use the term 'stockpiled gains', which refers to any trust structure gains that have not been distributed within 12 months of the end of the tax year in which they arose.

The tax rules stem from the substantial revision to the offshore income tax charging provisions brought about as a result of *Vestey v CIR* [1980] STC 10 when the Law Lords, now the Supreme Court, reversed 30 years of tax practice based on an earlier House of Lords decision. At that time, the highest rate of income tax was 60% and CGT was 30%. So the tax rules now require that distributions and benefits must be 'matched' against relevant income (to achieve the highest tax yield) before any distribution can be taxed as capital.

Many of the tax rules directly contravene trust law, where a 'capital payment' means a payment from trust capital. The tax rules sit apart from trust law reality by requiring that, in some circumstances, a 'trust capital payment' will be taxed exclusively as liable to income tax.

The legislation is widely drafted so that even if trustees, in breach of trust, apply trust benefits to a non-beneficiary who is UK resident, that individual will be treated as a beneficiary for all income tax and CGT purposes.

Calculating tax liabilities

Distribution payments and trust benefits provided are matched in the following order:

1. against all available 'relevant income'; then when 'relevant income' is exhausted;
2. against all available OIGs – the usual TCGA 1992 s 87 matching procedure, treating all OIGs as a single pool, but taking later years before earlier years (LIFO); then when all available OIGs are exhausted; and
3. against stockpiled gains on a LIFO basis.

The individual fiscal circumstances of a taxable beneficiary are then relevant to determine the rate of income tax or CGT payable on the taxable benefit. So, for example, if an individual without any other income or chargeable gains for a tax year receives a taxable trust benefit of £10,000, no tax will be payable. Either the income will be absorbed by the single person's allowance or capital will be absorbed by the individual's personal annual CGT exempt amount under TCGA 1992 s 3.

Tricks the draftsman thought of first

There are differences in treatment between income and capital.

'Relevant income' continues to be regarded so until it is taxed in the UK. Let's say a non-resident trust distributes all of its accumulated £100,000 relevant income to a non-UK resident beneficiary and then distributes £100,000 of realised chargeable gains to a UK resident beneficiary. In this case it will continue to be treated as having £100,000 of 'relevant income' and that will be matched against the benefit received by the UK resident.

The converse is true of stockpiled gains. Such gains (and OIGs) distributed to a non-UK resident will be treated as distributed. So offshore trustees with no relevant income that distribute their £100,000 stockpiled gain/OIGs to a non-resident beneficiary before distributing £100,000 to a UK resident beneficiary (B) will ensure that B does not incur an immediate tax liability.

But – there is a catch in the tail – TCGA 1992 s 87A requires that any such untaxed benefit will be 'matched' against any subsequent chargeable gains realised within the trust structure, and will be taxable in the year those gains are made. This may be several years after the distribution.

Another anomaly

Stockpiled gains, when matched against taxable distributions, may attract an additional CGT charge under TCGA 1992 s 91, depending on how long the gains have lain offshore.

Assume that B receives a taxable distribution, matched against stockpiled gains, that exceeds his annual CGT exempt amount, so that this becomes payable at 20% – the rate on some disposals effective for 2016/17. The rate of tax payable will be increased by 2% (10% of the effective rate of CGT under TCGA 1992 s 91) each year up to a maximum six years since the gain arose. The maximum rate of CGT payable in those circumstances can now be 32%.

Practical trust law problems

If B receives £100,000 that is not immediately taxable, assume that in the next tax year, before gains arise, he is excluded from benefit under the trust. He will then not have any legal right as a matter of trust law to obtain information from the trustees on any subsequent trust gains. As a matter of trust law there is no solution to that problem. Trustees will be reluctant to breach confidentiality and face risk of suit from other beneficiaries by divulging information to a non-beneficiary – and B will then be in breach of his tax filing obligations by not declaring that the trust has realised a gain that should be matched against his £100,000 distribution.

Further, a settlor who falls within TCGA 1992 s 86 footnote 1 (namely, trust gains are treated as his personal gains) will similarly:

- have no rights to information about trust gains unless he is a beneficiary or protector. He is unlikely to be a trustee because we are dealing with non-resident trusts; and
- have no rights to receive a trust distribution to finance payment of CGT on trust gains imputed to him personally.

TCGA 1992 Sch 5 para 6 gives the settlor a debt claim against the trustees in those circumstances to recover any CGT the settlor has actually paid. But there can be legal difficulties in enforcing such a claim cross-border against trustees of a trust that may be governed by Jersey or Bahamian law.

Reducing tax liabilities

Trustees can make loans to UK resident beneficiaries. The ‘benefit’ of an interest-free loan is taxable at the ‘official rate of interest’ (currently 4%), but it may be possible to structure loans in order to avoid such an annual tax liability. Trustees may be able to invest seed capital into a UK business start-up without creating any UK tax liabilities.