A. UK DOMICILIARIES

1. INCOME TAX

(a) Pre-conditions

- Trust must be discretionary or accumulation (because the income of a fixed-interest trust is treated as that of the life-tenant: Williams v Singer [1921] 1 AC 65).
- All the trustees must be non-resident (ITA 2007 s 475).
- The income must be foreign source (because UK income is subject to UK tax: Colquhoun v Brooks (1889) 14 App Cas 493). Where income accrues directly to a trust with UK beneficiaries the limitation to tax withheld does not apply: ITA 2007 s 812.
- The settlor and his spouse must be totally excluded from benefit: ITTOIA 2005 s 624; ITA 2007 ss 720-7.
- The settlor and his spouse must not receive any actual benefit, loans, or repayment of loans: ITA 2007 ss 727-30 and 724; ITTOIA 2005 s 633.

(b) What can be achieved?

- Avoidance of tax insofar as income is accumulated.
- Note: income may be subject to withholding tax where it arises which would be credited against UK tax if the income were received by a UK entity.
- Distributions of income or capital are tax-free only if to non-residents:

  (1) Income distributions received by UK residents are taxed under ITTOIA 2005 s 683 (annual payments).

  (2) Capital distributions received by UK residents are taxed under ITA 2007 ss 731-5 to the extent of income accumulated in the trust or any underlying company (with no credit for withholding tax suffered as the income arose).

- If capital is distributed to a UK resident, a deferral has been achieved, but at the cost of unrelieved double tax if the income originally suffered withholding tax.
- Distributing income as income results in a tax charge on such income. But prior gross accumulation means the fund generating the income is greater.
- Distribution of capital to non residents converts the deferral to avoidance. NB - the rule in TCGA 1992 s 10A requiring non residence for five tax years does not currently apply to income tax. There are two exceptions, namely in taxing remittances by
remittance basis users (ITTOIA 2005 s 832B) and in relation to Offshore Income Gains.

(c) Impact of recent changes

- If distribution is intended, interest in possession secures dividend rates and tax credit.
- The dividend rates are 10% basic rate, 32.5% higher rate and 42.5% top rate (ITA 2007 ss 8 and 19).
- Where the tax credit under ITTOIA 2005 ss 397 and 397A is available the effective dividend rates are nil basic rate, 25% higher rate and 36.1% top rate.
- The tax credit is inter alia available on (ITTOIA 2005 ss 397 and 397A)
  a) UK source income
  b) Dividends from holdings which comprise less than 10% of the distributing company’s share capital
  c) Dividends from certain offshore funds in corporate form
- Credit may also be available for foreign withholding tax.

2. CAPITAL GAINS TAX

(a) Pre-conditions

- All the trustees must be non resident (TCGA 1992 s 69).
- The assets must not be used in a UK business carried on by the trustees: TCGA 1992 s10.
- If the settlor is still alive and UK resident, he, his children and their respective spouses must be excluded: TCGA 1992 s86 and Sch 5.
- If the settlement was made after 17 March 1998 (or is a pre 1998 settlement which has been tainted), the settlor’s grandchildren and their spouses must also all be excluded: see TCGA 1992 Sch 5 paragraphs 2(3)(da) and 2A.

(b) What can be achieved?

- Sheltering may still be achieved if:-
  (a) The persons listed above are all excluded.
  (b) The settlor is dead.
  (c) The settlor is non resident.
  (d) The return is taxed as income (and the settlor and his spouse excluded).
- Capital must not be distributed to UK resident and domiciled beneficiaries because:-
  (1) The capital so distributed is taxed by reference to past and future s 2(2) amounts (i.e. gains) whether realised in the trust or any underlying company: TCGA 1992 s87.
(2) If the tax is by reference to past s 2(2) amounts it may be increased by notional interest which can take the rate to 44.8%: TCGA 1992 s 91.
- Watch the rules as to trustee borrowing (TCGA 1992 Sch 4B and 4C).
- Note that the assets settled must not be pregnant with gain as holdover relief is not available.

(c) Impact of recent changes
- LIFO now applies to s 87 (s 87A).
  - This means there is an incentive to distribute an amount equal to gains in the same or the next tax year (but note that any such distribution will attract income tax under ITA 2007 s 731-5 insofar as the structure retains relevant income and tax under the Offshore Fund (Tax) Regulations 2009 (SI 2009/3001) insofar as the trust has OIGs).
  - Trusts within s 86 can still avoid CGT by ensuring the return is or is treated as income. May be worthwhile if long-term retention intended.
  - The current 28% rate of CGT means that capital payments subject to CGT are taxed and rates of 28% - 44.8%, assuming the recipient is a higher rate tax payer. This is normally less than the tax which is payable where ss 731-5 apply, but this would not be so if the tax payer is not a top rate tax payer and CGT matching is with historic trust gains.
  - Small capital distributions matched with trust gains attract the CGT exemption, currently £10,600 (assuming the distribution is not taxed under ss 731-5 or as an OIG).

(d) Transitional
- The s 2(2) amounts (i.e. trust gains) for 2007-08 and prior years computed as per rules then obtaining.
- This means the gains are as reduced by indexation and taper.

3. INHERITANCE TAX

(a) Importance of domicile
- Liability to IHT turns on the domicile (or deemed domicile) of the settlor when the settlement is made: IHTA 1984 s48(3).

(b) Entry Charge
- No PET on creating the trust. This means IHT at 20% unless:
  (a) Nil-rate band.
  (b) Business Property Relief.
  (c) Other reliefs (e.g. normal expenditure out of income - IHTA 1984 s 21).

(c) Relevant property charges
- Maximum rate of 10 yearly charge is 6%.
- Relevant property regime applies (as respects inter vivos settlements created after 22 March 2006) even if interests in possession subsist.
- No protection from the 10-yearly charge unless either:
  (a) Nil rate band (currently £325,000).
  (b) Business property relief.
- No charge if an interest in possession is created or if an interest in possession terminates (unless a qualifying interest in possession).

(d) Exit charges
- Exit charge at rate of up to 6% when property ceases to be relevant property.
- May be displaced if the distribution is taxed under ITA 2007 s 731 (IHTA 1984 s 65(5)(b)).

(e) GWR
- Trust property treated as remaining in the settlor’s estate unless he is excluded, or virtually excluded, from benefit, whether by contract or otherwise (FA 1986 s 102).
- The fact that the property is GWR property does not preclude 10 yearly charges.

(f) Overall impact
- Key issue is transferring value into the settlement.
- Thereafter 6% every 10 years may be acceptable (particularly if tax-free accumulation of income or offshore income gains is being achieved).
- Testamentary offshore settlements may be attractive (because IHT chargeable in any event).
- Now able to create and revoke interests in possession without IHT consequences.
- Essential to ensure complete exclusion of settlor.

B. NON DOMICILIARIES

1. Income Tax
   a) Settlor as a beneficiary
   - If the settlor is non domiciled and a remittance-basis user he and his spouse are not subject to income tax if they are beneficiaries provided there is no UK income and foreign income is not remitted: ITTOIA 2005 s 648(3); ITA 2007 ss 726 and 730.
   - Note that a remittance of income by the trustees or any underlying company results in tax for the settlor if he and his
wife are beneficiaries. This is because the trust is a relevant person (ITA 2007 a 809M).
- New investment relief does apply to trust remittances (ITA 2007, 809 VA (3) (a)).

b) Distributions
- Income distributions to a resident remittance-basis user beneficiary are not taxable if made abroad and not remitted to the UK.

c) Capital distributions
- Capital distributions to a resident remittance-basis user beneficiary are not subject to income tax if (1) the beneficiary is the settlor or (2) neither the settlement nor any underlying company has UK income, no foreign income is remitted, and the distribution is not remitted to or enjoyed in the UK (ITA 2007 s 735).

2. Capital Gains Tax

a) The settlor
- Capital gains cannot be assessed on the settlor on an arising basis if he is non domiciled regardless of whether he or members of his immediate family are beneficiaries: see TCGA 1992 s 86(1)(c). This is so regardless of whether he is a remittance-basis user.

b) Beneficiaries
- If a beneficiary in receipt of a capital payment is a remittance-basis user, any gain treated as accruing under s 87 is taxable on the remittance basis.
- It is treated as remitted if the capital payment is remitted or enjoyed in the UK (TCGA 1992 s 87B).
- The fate of the matched s 2(2) amount is irrelevant as is whether it accrued on UK or non UK assets.

c) Transitional
- Tax not charged if matched capital payment or s 2(2) amount is of 2007-08 or prior (FA 2008 Sch 7 para 124).
- Tax not charged if matching is with s 2(2) amount of 2008-09 and post if and insofar as a rebasing election has been made and the s 2(2) amount includes gains which accrued before 5 April 2008 (Sch 7 para 126).
- These reliefs apply to all non-domiciliaries, not just remittance-basis users.
- Note that LIFO applies in matching gains to capital payments (TCGA 1992 s 87A)
3. **Inheritance Tax**

a) **Excluded property**
   - IHT is wholly avoided provided:
     (a) The assets are non UK situate (or are UK authorized funds).
     (b) The settlor was not domiciled or deemed to be domiciled in the UK when the settlement was made: IHTA 1984 s 48(3).

b) **Deemed domicile**
   - Deemed domicile (IHTA 1984 s 267):
     (i) Resident in the UK at any time in the last 17 out of 20 tax years (including the present one); and
     (ii) Domiciled in the UK at any time within the last three years.

4. **Overall Effect**

a) The typical excluded property settlement
   - Settlor a beneficiary, often the principal beneficiary.
   - No UK investments
   - Capital and income segregated
   - Remittances by the settlor from capital distributions
   - No remittance of income

b) Potential difficulties
   - Under TCGA 1992 s 87, remitted distributions may be subject to CGT by reference to trust gains [ITA 2007 ss 731-5 are not in issue as the settlor is the transferor]
   - May be less of an issue from 6 April, as bank account currency gains will not be included in computing trust gains (new TCGA 1992 s 252)

ci) UK investments
   - IHT exposure is avoided provided the investments are owned through a holding company
   - Purchase must be funded out of clean capital
   - Income arising on the UK assets is taxable on the settlor on an arising basis under the transfer of assets code
OFFSHORE TRUSTS AND PRACTICAL CAPITAL TAX ISSUES

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