

DEEMED DOMICILE CHANGES – TRUST PROTECTIONS

Notes on practical points and areas of uncertainty

TAXGUIDE 02/21

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INTRODUCTION

These notes have been prepared by committee members of STEP, ICAEW and the CIOT to highlight practical issues and uncertainties in the statutory provisions for trust protections as introduced by Finance (No 2) Act 2017.

The notes have not been agreed by or commented upon by HMRC and no part of these notes should be taken as representing HMRC's views.

The notes are intended to assist professional advisers in considering the issues. They do not constitute advice and are not a substitute for professional consideration of the issues by such a professional adviser in each client's specific context.

Neither STEP, ICAEW or the CIOT assume any liability to any person in respect of these notes. The notes are published to assist those who have an interest in some of the difficult areas created by Finance (No2) Act 2017 changes, but the bodies express no opinion themselves as to the correct answers.

References to 'HMRC's guidance' are to the guidance published by HMRC on GOV.UK on 31 January 2018, as updated on 2 February 2018 at the following link:

<https://www.gov.uk/government/publications/trust-protections-and-capital-gains-tax-changes>

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1. MEANING OF 'PROVIDED'

The words 'provided ...for the purposes of the settlement' connote an intention on the part of the provider to confer some bounty on the settlement or its beneficiaries (see *IRC v Leiner* (1964) 41 TC 589). Under the tainting rules an addition of value to the property comprised in the settlement is deemed to be a provision without regard to intention, but the basic requirement that bounty be intended is preserved by the rule requiring the provision of property or income to be ignored if there is no intention to confer gratuitous benefit.

It is considered that inadvertent additions of property or income do not therefore taint a protected settlement.

Loans represent an exception to the rule that tainting does not occur if there is no intention to confer gratuitous benefit. It is considered that with loans the sole issue is whether the statutory requirements relating to the payment of interest are satisfied.

If property is transferred to the trust in pursuance of a liability incurred before an individual becomes deemed domiciled, it is not considered tainting occurs as the provision is made when the obligation to provide the property is incurred. The disregard in TCGA 1992 Schedule 5 paragraph 5B(2)(f) and the equivalent income tax provisions might indicate that property is provided when it is transferred to the trust not when the liability is incurred. It is however considered that the specific disregard in Schedule 5 paragraph 5B(2)(f) is for the avoidance of doubt. But the liability must be legally binding prior to the settlor becoming deemed domiciled even if it is conditional on certain events occurring.

2. DE MINIMIS

HMRC has given no indication they would be willing to apply a de minimis disregard even though it would obviate the administrative burden of establishing evidence of intent or inadvertency. It follows that even a minimal addition can taint a settlement. However, in practice many minimal additions are unintentional and here absence of gratuitous intent would prevent tainting.

3. SETTLEMENT OF WHICH THE SETTLOR IS A BENEFICIARY – MEANING OF 'BENEFICIARY'

The trust protections are lost both when property or income is provided directly or indirectly by the settlor and where the provision is by the trustees of another settlement of which the settlor is the settlor or a beneficiary. Most settlements contain a wide power of addition so virtually any settlement from which the settlor is not specifically excluded enable the settlor to be added as a beneficiary even if that person is not currently a beneficiary. But, unless and until someone is added, they are not in fact a beneficiary, and the trustees do not need to consider whether to confer any benefits on them.

It is therefore considered that a 'beneficiary' in this context means someone who is currently a beneficiary of the settlement. Until a person is added as a member of the class of beneficiaries that person is not a beneficiary.

4. WHETHER ONGOING WORK OR EMPLOYMENT BY THE SETTLOR TAINTS A PROTECTED SETTLEMENT

It is not considered that the settlor remaining in the employment of a company or working in a business in which the settlement has an interest constitutes an 'addition of value' to the settlement provided the remuneration package is such as would be agreed at arm's length if neither he nor the settlement had any interest in the shares/business. If this condition is not met, it would have to be considered whether his work/employment was in fact adding value to the settlement and whether by working the settlor intended to provide the settlement with a gratuitous benefit.

A trust may own shares/share options or an interest in a business which have been awarded as a result of the settlor's work/employment. These awards may be subject to vesting provisions (or the economic equivalent) under which the award may increase in value the longer the settlor works or if certain targets are met but which may also decrease in value or become worthless if the settlor ceases to work in the business or for the relevant company.

As long as the award was held by the trust before the settlor became deemed domiciled, the fact it may increase in value as a result of the settlor's work is not in general considered to amount to a provision of property or an addition of value. The reason for this is that any gratuitous intent existed only when the award was made/transferred to the trust. The settlor has no gratuitous intent when continuing to work in the business or for the company.

The position may be different where the overall terms of the work/employment were or are not arms' length or the settlor deliberately acted with the objective of enhancing the value of the award held by the trust or the terms of the award were otherwise contrived to achieve this result. It is likely that, in these circumstances, such an arrangement would taint the settlement.

5. RETENTION OF INCOME DUE TO LIFE TENANT

Where trustees of a life interest settlement retain income due to the life tenant who is the settlor they hold the income as nominee for the life tenant. Income due to a life tenant who is the settlor invariably leaves 'the settlement' and becomes held on bare trusts or nomineehip. So there is no question of the income being added to the settlement. Tainting would only occur if the settlor expressly or impliedly added the income to the trust fund.

6. GUARANTEES

Where trustees borrow commercially from a bank and pay an arm's length rate of interest the bank may require the settlor to guarantee the loan. The bank does not require collateral for the guarantee. No payment is made by the trustees to the settlor for giving the guarantee as there is no realistic risk that the trustees will not be able to repay the loan.

SP5/92 takes the position on a generic basis that the guarantee by the settlor of an obligation of the trustees is to be treated as the provision of property for the purposes of the settlement. It was widely considered SP5/92 was incorrect in taking this position on the basis that there is no provision of property to the trustees unless and until the guarantee is called. In the case of a loan the trustees have borrowed money but they have the obligation to repay the money along with an arm's length rate of interest. There is no risk in reality that they will default on their obligations.

In practice, a third party providing a guarantee to the bank in these circumstances would charge a fee. On one view, failure by the settlor to charge a fee does not taint the settlement as it is not an addition of value to the particular items of property comprised in the settlement. The more prudent view is that this distinction is too technical, and accordingly that failure to charge a fee would amount to tainting.

A secured guarantee could on one view be said to be the direct or indirect provision of the property over which security is provided even though the property in question never becomes comprised in the settlement. It is considered necessary for an arms' length fee to be charged in order to avoid any risk of the borrowing trust being tainted. The fee may be small if there is no realistic prospect of a default.

7. PRESERVING THE VALUE OF TRUST PROPERTY RATHER THAN INCREASING IT

It is not considered the settlor taints a settlement where he keeps a trust property in good order and repair if he is living rent-free in the property and the cost to the settlor is no more than the rent he would have to pay if he was renting the property on arm's length terms. Should the settlor pay for improvements, it is considered tainting occurs if the value of the property is increased by the improvements.

8. PROPERTY MANAGEMENT

It is considered that tainting does not occur if the trustees own rental property and the settlor assists the trustees on an occasional basis with certain practical day-to-day matters such as interviewing new tenants, assisting with rent collection and generally in answering practical queries and passing these onto the trustees. The position could be otherwise if the settlor is in the business of property management and does not charge a fee.

9. INVESTMENT SUGGESTIONS

It is not considered tainting occurs where the settlor suggests investments to the trustees. Trustees are under a duty to take account of the views of the settlor and the beneficiaries.

This is the case even if the investment opportunity is not one to which the trustees would have had access themselves as long as they pay the same amount as other investors for their investment. An opportunity is not “property” and the investment (which is property) will have been acquired on arms’ length terms and without any gratuitous intent.

Tainting could however occur if the settlor is an investment professional and provides gratuitous investment management services of a kind that independent clients would pay for. Here the addition of value is likely to be the fee not charged.

10. REDUCED MANAGEMENT FEES OR OTHER PREFERENTIAL TERMS DUE TO WIDER RELATIONSHIP WITH SETTLOR

The trustees of a protected settlement may invest the trust fund in a professionally managed investment fund. The settlor may be an employee or partner in the fund or the manager along with others and does not control the fund terms and conditions. It is common in private equity and private investment funds to provide that as long as an individual is an employee or partner management fees are not charged or are set at a lower amount for the individual, his family and related trusts than would be the case for a third party investor. If the individual’s employment or work relationship with the fund ceases this benefit also ceases. It is not considered tainting occurs where the investor is a related trust provided the settlor does not control the fund terms and conditions and would not receive any additional salary or benefit if the trust did not invest in the fund.

11. ADDITION OF VALUE BY INACTION – EG, ALLOWING AN OPTION TO LAPSE

The release by the settlor of an option to acquire trust assets on advantageous terms taints the trust (see HMRC guidance paragraphs 5.4 and 5.5).

It is considered the outcome would be the same if the settlor knowingly let the option lapse.

12. INCOME OF INTERMEDIATE COMPANIES IN A CHAIN – WHETHER PROTECTED FOREIGN SOURCE INCOME (PFSI)

For the purposes of ITA 2007 sections 721A and 729A income of an underlying company can be PFSI where either:

- a) The trustees are participators in the company to which the income arises; or
- b) The company to which the income arises is the last company in a chain of companies and the trustees are participators in the top company in the chain.

Read literally, this could mean income arising to intermediate companies in the chain cannot be PFSI. However, a purposive construction avoids this result, if ‘the last company in the chain’ is

taken to be the company which has received the income, even if that company may have direct or indirect subsidiaries. It is considered this purposive construction must be correct.

13. CAPITAL SUM PROVISIONS ITA 2007 SECTIONS 727-730 ITA – WHETHER PFSI

Income arising within a company owned by a settlement is PFSI for the purposes of the ‘capital sum’ provisions in the transfer of assets abroad rules (ITA 2007 sections 727 – 730) if the trustees become participators in the company (or the top company of a chain) as a result of a relevant transaction and the relevant income becomes the income of the company as a result of that same relevant transaction. Read literally, this means the income of a wholly owned underlying company may not be PFSI for the purposes of the capital sum rules.

For example, if a settlor establishes and capitalises the company before he transfers the shares in the company to the trust, the trustees become participators as a result of the transfer of the shares to the trustees but the income arises in the company as a result of the original capitalisation of the company. On the face of it, these are different relevant transactions.

Again, it is considered that the legislation can be read purposively in order to reach what must have been the intended result. It could be said that (indirectly) the trustees have become participators in the company as a result of the settlor transferring assets to the company and therefore acquiring the shares which were transferred to the trustees. This purposive interpretation is supported by the fact that income can be PFSI where there is a chain of companies. It would be impossible for the trustees to become a participator in the top company as a result of the same relevant transaction which gives rise to income in the bottom company. A narrow interpretation of this requirement therefore seems unlikely to be correct albeit full white space disclosure should be made where a purposive interpretation is relied on.

14. CAN EXISTING LOANS BE AMENDED RATHER THAN REPLACED

A loan to the trust for a fixed term of ten years repayable in 2026 might have been made before 6 April 2017 on non-arm's length terms by the settlor. There is no tainting as the liability was incurred before 6 April 2017. As long as the loan is put on arm's length terms before the end of the fixed term within the statutory definition it is considered there is no tainting even if it is documented as a continuation of the existing loan rather than the making of a new loan. Under the statutory definition interest at the official rate must be payable and paid at least annually.

15. LOAN TERMS BACKDATED SO INTEREST-BEARING AT THE OFFICIAL RATE FROM THE DATE ON WHICH IT WAS MADE

It is not considered that an interest-free loan can be prevented from tainting a settlement if, after the loan has been made, the trustees agree retrospectively to pay interest.

16. LOANS TO UNDERLYING COMPANIES - WHETHER ARM'S LENGTH RULES CAN APPLY.

The provisions regarding arm's length loans are expressed in terms of loans to or interest paid to the trustees of the settlement. It is not considered this prescriptive language extends to loans to or interest paid to underlying companies. On a literal view at least the exclusion of transactions at arm's length or not intended to confer gratuitous benefit do not cover these loans either. However such loans would only constitute tainting if property has been provided to the settlement or value added to it. It is therefore considered loans on arm's length terms do not amount to tainting. Strictly the requirement that interest be paid as distinct from compounded would not be in point, but it is considered that to run an argument on these lines would be provocative.

HMRC's published guidance indicates that in HMRC's view loans to and interest paid to underlying companies should be treated in the same way as loans to and interest paid to the settlement. Should interest at the official rate differ from the arm's length it will be a matter of judgement as to whether to rely on apparent HMRC practice.

17. LOANS TO OR FROM UNDERLYING COMPANIES

A loan or other transaction between the trustees and a company wholly owned by the trust cannot result in tainting as no value is being provided to the trust structure.

18. CHANGE IN OFFICIAL RATE OF INTEREST

It is considered that a loan to a settlement for a fixed term does not amount to tainting if either:

- a) the interest rate throughout the term equals the official rate at the start of the term;
- b) the interest rate during the term varies according as to variations in the official rate.

It is considered that on a demand loan the interest rate must vary in line with variations in the official rate. The example at category (d) in para 5.5 of the guidance may however signify HMRC take a different view.

19. SWISS FRANC AND JAPANESE YEN LOANS

There are different official rates for loans denominated in Swiss francs and Japanese yen (see EIM26106) subject to certain conditions. It is not considered that these separate rates must be used in respect of loans denominated in these currencies as they apply only to loans made by reason of employment to individuals who normally live in Switzerland or Japan.

20. RECEIPT AND RE-LENDING OF INTEREST

It is not considered tainting occurs if interest is paid using further funds provided by the lender, provided the provision is itself a loan on arm's length terms as required by the legislation.

21. INDIRECT PROVISION OF PROPERTY/INCOME OR ADDITION BY A COMPANY OWNED BY THE SETTLOR

It is considered that a loan (unless on arms' length terms) or other provision to the trust by a company owned by the settlor normally amounts to a provision of property by the settlor. This may not be so if the provision is for the purposes of the company's business and is in the interests of the company as distinct from those of its shareholder(s).

22. REIMBURSEMENT OF TAX

The published guidance indicates at the end of 5.5 that:

A failure by a settlor to reclaim tax from the trustees could taint a trust, but provided that the settlor claims reimbursement within a reasonable time the trust will not be regarded by HMRC as tainted.

In relation to income which arose before 6 April 2017, it is considered that if, prior to that date a reasonable time has passed since the right of reimbursement first arose, tainting has not occurred. This is because any addition would have taken place when the right had not been exercised within a reasonable time after it has arisen. There is no further addition if the settlor continues to fail to exercise the right.

Reimbursement of tax paid by the settlor is not a benefit under the transfer of assets rules provided the right to reimbursement is statutory. The transfer of assets code does not provide for statutory reimbursement but ITTOIA 2005 s 646 and TCGA 1992 Sch 5 para 6 do.

23. INHERITANCE TAX IMPLICATIONS OF LOAN INTEREST PAYABLE AT THE OFFICIAL RATE

The tainting legislation sets out the circumstances where a loan is considered to be on 'arm's length terms'. However, there are no comparable inheritance tax provisions, which may produce uncertainties in some circumstances. For example, trustees may make a ten-year fixed term loan to a UK resident settlor at a rate that does not exceed the official rate of interest in circumstances where a bank would charge interest at a rate that exceeds the official rate of interest. The settlor cannot pay a higher rate without tainting the settlement. It is considered that the provisions of IHTA 1984 section 10 would apply because paying interest at no more than the official rate is not intended to confer a benefit on any person and is required under the capital gains tax and income tax rules for the purpose of ensuring that the loan is deemed to be on arm's length terms.

24. MEANING OF ITA 2007 SECTION 731(1A)

Section 731(1A) prevents a charge where the recipient is non-resident when he receives the benefit. On a literal reading this does not apply where the person abroad is a settlement or underlying company and the recipient of the benefit is the settlor. It is considered that section 731(1A) is intended to be read with section 733A and ensure the settlor can be charged on a benefit received by the settlor's non-resident spouse or minor child but not if the non-resident is the settlor. It follows that section 731(1A) should only be applied to tax the settlor if payments are made to the settlor's non-resident close family member and the settlor is UK resident, not where the settlor himself is non-resident and payments are made to him (or a close family member). An alternative reading would put the settlor in a worse position than a UK domiciliary becoming non-UK resident particularly as the remittance basis could not apply. This appears to be the approach adopted by HMRC (see paragraph 3.25 of their guidance).

The charge under section 731(1A) is only made if the relevant income matched to the benefit is PFSI (see section 721(3BA)). It is considered that in determining which relevant income is matched to the benefit FIFO must be used by virtue of ITA 2007 section 735A and that relevant income cannot be PFSI unless it arose after 5 April 2017 as the changes only apply for the tax year 2017/18 onwards. Income before that date cannot be PFSI. The amendments made to section 726 introducing sub-sections (6) and (7) refer specifically to PFSI and earlier years thereby providing further confirmation.

25. OFFSHORE INCOME GAINS ("OIGS")

HMRC currently take the position OIGs and accrued interest are not PFSI where the settlor is deemed UK domiciled. Many advisers recommend filing on the basis these items are PFSI, but with full white space disclosure. It is considered full disclosure is essential.

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