The Offshore International & Taxation Review

OVERSEAS TRUSTS & CGT: A SIMPLE[TONS] APPROACH[1]

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(For definitions of *'residence', *'ordinary residence' and *'domicile' - see Appendix).

In appropriate circumstances the creation of non-resident trusts can still be very tax effective; in particular:

IHT

As regards a settlor domiciled outside the UK when the settlement is made, provided the assets are also outside the UK the settlement will be, and will remain excluded property for IHT purposes, the domicile of the beneficiaries being irrelevant. Accordingly, any non-domiciled settlor who is envisaging acquiring or reacquiring a UK domicile should urgently grasp the nettle and set up the appropriate settlement before he acquires such UK domicile. Moreover, the CTO accept that the property remains excluded - i.e. not liable to IHT - notwithstanding that the settlor has reserved a benefit in the asset gifted - (there are rumors however, that this long standing Revenue practice may change!)

In the case of discretionary trusts which are not of such excluded property (i.e. because the settlor is UK domiciled) these trusts no longer suffer the annual periodic charge but only the ten-year periodic charge as for resident discretionary trusts.

Capital Gains Tax - Non-Resident Trusts - Restrictions and Scope

For CGT, if the majority of the trustees are non-UK resident and the general

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administration is carried on outside the UK, the trustees will not themselves be taxed. In certain circumstances, UK resident professional trustees can be treated as non-UK resident see TCGA s.69.

In the light of FA 1991 sections 83-92 and Schedules 16-18 (now TCGA sections 80-98 and Schedule 5), it is largely true that Monday, 18th March 1991, and Tuesday, 17th March 1998, proved to be black days for non-resident trusts subject to one year's respite (i.e. until 5th April 1999) for offshore trusts created prior to 19th March 1991). FA 1998 section 132.

For definition of non-resident trusts see TCGA section 69(1).

The legislation now taxes non-resident trusts created before or after 19th March 1991 in three main situations discussed below as to the impact and remaining scope.

(1) Trustees Ceasing to Be UK Resident TCGA Section 80

Namely when the UK trustees retire and new non-resident trustees are appointed, the assets of the trust are revalued as if they had been sold at full value and taxed to CGT on the UK trustees. Previously the assets may well have been put into trust years before at a very low value via holdover relief and on exportation only that low value was taxed.

Trustees of a non-UK resident trust for UK CGT purposes are not themselves liable to UK CGT for capital gains realised by them - (but see (2) and (3) below).

Remaining scope: Where the present value is itself manageable but future growth is anticipated, e.g. newly formed businesses, assets settled by Will, assets temporarily depressed in value.

(2) Charge on the Settlor (TCGA Section 86)

(a) Position pre-Spring 1998 Budget: 17th March 1998

Before the 1991 anti-avoidance legislation, a tax payer had relished the use of non-resident trusts because he did not have to be excluded from benefiting - a "cake and eat it" situation. Since then, the settlor is taxed on the non-resident trust gains, if he, his spouse, children and step-children (not limited to minors) or their spouses or a company controlled by him or an "associated company" and/or such relatives are interested directly or indirectly in capital or income of the trust, i.e. "qualifying settlement" see FA 1986 Schedule 5 paragraph 9. See extension to grandchildren below.

Up to 17th March 1998, there was no CGT charge under s.86 if the settlor was not UK domiciled or non-UK resident when he set up the trust and when the trustees made the distribution to beneficiaries. In such circumstances, the fact that he and/or the beneficiaries were interested was immaterial. Therefore, for such "foreign" settlors, the scope remains, i.e. for gains accruing to trustees pre 17/3/98 or capital payments received pre 17/3/98! (TCGA 1992 section 87) post 17th March 1998 - As to "Robinson" changes see below.

(b) Charge on settlor - Position post-Spring 1998 Budget: 17th March 1998 FA 1998 sections 129-132

- Gains made by non-resident trusts set up before 19th March 1991 were generally not subject to the settlor charge rules unless the trusts became "tainted", e.g. if assets were added after that date.

  As from 6th April 1999 gains of such pre March 1991 trusts will be treated in the same way as post March 1991 as regards chargeable disposals made on or after 6th April 1999 FA 1998 section 132.

Trustees and advisers should consider appropriate re-organisation, e.g.

- exclusion of the defined relatives and companies they control as beneficiaries (subject to certain exceptions for minors, unborn beneficiaries etc)

- winding up of the trust. Let assets be owned by *individuals* absolutely, i.e. outside trusts: but other taxes e.g. IHT have to be considered!

- repatriation of the trust to UK (but without sale of the interest - see Press Release 6th March 1998 and FA 1998 section 128).

- convert capital into **INCOME** gain, e.g. property dealing rather than investment (but note wide definition of capital payments TCGA section 97(1)).

Grandchildren's Trusts FA 1998 Section 131 and the Settlor Charge

Grandchildren of the settlor or his spouse or spouses of grandchildren come within the definition of close relatives but only for trusts created on or after 17th March

1998 or earlier trusts that are "tainted" e.g. by additional gifted assets - with some exceptions. Grandchildren's trusts can remain the "golden trusts". For tainting Inland Revenue Statement SP5/92 continues to be relevant. FA 1998 section 131. Moreover trusts that include such grandchildren are protected if made pre 20th March 1991.

As in the case of pre 1998 offshore trusts, there can be no section 86 charge on the settlor if:

- the settlor is either non-UK domiciled or non-UK resident or ordinarily resident in the relevant tax year

- the settlor has died in the tax year (contrast section 87).

(3) Charge on the UK Beneficiaries (TCGA Section 87)

As a general rule, the benefit of offshore trusts has only been one of deferral - and if a UK resident and domiciled beneficiary receives benefits (as widely defined and including when a beneficiary becomes absolutely entitled; favourable loans, and use of a property rent free), that is a capital payment on which he is charged CGT. Meanwhile, the non-resident trustees are able to invest gross, i.e. without a CGT charge.

There is therefore also a supplementary charge of 10% on the tax due - a grossing up process. This supplementary charge applies to a capital payment made to a UK resident beneficiary on or after 6th April 1992, and is at the rate of 10% pa on the tax otherwise payable for each year for which gains remain undistributed up to a maximum of six years (i.e. a maximum of 4% pa of the gain: 10% x 40% x 6 = 24% aggregate - which can amount to a total CGT of 64%). This should be considerably less than the tax free investment return/yield received by the non-resident trustees gross (say 10% pa). The aim of this supplementary charge is clearly to encourage non-resident trustees to make capital payments to UK beneficiaries.

As regards the non-UK domiciled or non-UK resident settlor - TCGA section 87 - referred to in (2) above, the CGT exemption ceases to apply to any gains realised and capital payments made on or after 17th March 1998 to beneficiaries domiciled and resident or ordinarily resident in the UK (see also below, particularly as to beneficiaries NOT UK domiciled or resident). "Taxation" 2nd April 1998 page 2 "gains realised by all trusts worldwide will potentially be within the UK capital gains tax net unless the offshore trustees will never distribute any capital to a beneficiary resident in the UK".

Contrast the position of the non-UK domiciled but resident individual (i.e. without a trust) who can avoid CGT on overseas gains by merely not remitting them! Also consider income distributions - no supplementary charge applies.

The charge on beneficiaries - whether as a capital payment or a supplementary charge - will not apply to non-UK resident *or* non-UK domiciled beneficiaries.

However, in these circumstances, the charge on the settlor on gains realised by offshore trusts (see (2) above) may still apply in its wide context but only under section 86, if the settlor is resident and domiciled in UK. Section 86 is assessed first, then section 87, not both.

In relation to non-UK residence, however, since 17th March 1998 under section 1 O A TCGA if the individual beneficiary is non-UK resident for less than 5 tax years, such individual will normally be liable to UK CGT on 6th April in the year of return including capital payments or benefits received by them from the offshore trust to the extent that there are trust gains at the time the payment is made or the benefit is received.

Gains attributed from trusts are no longer capable of being offset by personal losses of the settlor or beneficiary.

Interest free loans including those repayable on demand are subject to CGT under section 87 and even though the life tenant is the settlor/beneficiary - *Cooper v Billingham* [2000] STC 122 and Court of Appeal [2001] EWCA CIV 1041.

2.3.3 Income Tax

Overseas trusts can benefit from the remittance only, i.e. nest egg, basis under TA 1988 s.740 provided that the beneficiary of the income is not the settlor or settlor's spouse (in which event see TA 1988 ss.739-742 as amended). An overseas trust can therefore accumulate income free of UK income tax for the benefit of beneficiaries other than the settlor or settlor's spouse. Moreover income distributions can be made in appropriate dribs and drabs so as to be subject to UK tax at manageable rates and with maximum cash flow advantage. The ultimate benefit to be obtained is where the income is accumulated as above and the beneficiary then becomes non-resident and whilst retaining this non-resident status has the income distributed to him. Going non-UK resident has become more difficult; for income tax the foreign earnings deduction under TA 1988 s.93 and Schedule 12 is abolished from 17th March 1998, and for CGT it will normally take five years to acquire non-UK residence.

The House of Lords decided in *CIR v Willoughby* [1977] STC 995, that for the purpose of s.739, no liability arose because, at the time of making various single Premium Bond investments in the Isle of Man, the taxpayers were not ordinarily resident in the UK.

In order to counteract this decision, FA 1997 s.81 tightens these anti-avoidance provisions as from 26th November 1996:

- When the transfer is made, the transferor can still be caught by these anti-avoidance provisions even though non-UK resident at that time.

- Where a purpose of the transfer is to avoid any form of direct taxation the anti-avoidance provisions apply not just where income tax is sought to be avoided.

Under TA 1988 s.553C and SI 1999/1029 offshore and UK personal portfolio bonds (where the policy holder is in a position to select and vary the underlying investment) will be subject to an annual income tax charge for policy years ending on or after 6th April 2000 (except the last year). This will be at a rate of 15% of a deemed gain, equal to the aggregate premiums paid, plus the deemed gains of previous years, less any taxable amounts withdrawn in earlier years.

Residence of trustees and personal representatives FA 1989 ss.110 and 111. The House of Lords' decision *in Dawson v IRC* [19891 STC 473 decided that for income tax purposes in respect of non-UK source income, there is only liability to UK income tax if all the trustees are UK resident. FA 1989 s.110 provides that from 1989-90 onwards, if any one trustee is resident in the UK there is liability to UK income tax if the settlor was resident, ordinarily resident, or domiciled in the UK on creation of the settlement or at any time when he provided funds for it. NB: the new five-year non-UK residence rules for CGT FA 1998 s.127 incorporating new s.10A TCGA.

Offshore trusts have their cases - but are not for the faint hearted, and the Courts are likely to apply the purposive approach.

Appendix

Domicile - an individual's domicile is the country in which he has or is presumed to have his permanent home, and contains the dual element of actual residence and intention of remaining in that country permanently: *Winans v A-G* [1904] AC 287.

Domicile can be acquired by birth (domicile of origin); operation of law, e.g. an infant's 'dependent' domicile on his father or if dead, his mother; choice, i.e. changing one's domicile - a difficult matter to arrange.

IHT is based on domicile; CGT and income tax mainly on residence, although domicile can be relevant, e.g. as to remittances.

Residence and Ordinary Residence

Residence - Inland Revenue booklet IR20 states:

To be regarded as resident in the UK you must normally be physically present in the country at some time in the tax year. You will always be resident if you are here for 183 days or more in the tax year. There are no exceptions to this. A count is made of the total number of days you spend in the UK - it does not matter if you come and go several times during the year or if you are here for one stay of 183 days or more. If you are here for less than 183 days, you may still be treated as resident for the year under other tests...

Ordinary Residence - If you are resident in the UK year after year, you are treated as ordinarily resident here. You may be resident but not ordinarily resident in the UK for a tax year if, for example, you normally live outside the UK but are in this country for 183 days or more in the year. Or you may be ordinarily resident but not resident for a tax year if, for example, you usually live in the UK but have gone abroad for a long holiday and do not set foot in the UK during that year.