Tainting 'protected trusts': essential reading for trustees

Trustees administering trusts settled by non-UK domiciled individuals (non-doms) who are long term UK residents need to beware of not tainting structures post April 2017.

Significant changes were introduced with effect from 6 April 2017 to the taxation of non-UK resident trusts with non-dom settlors.

Protected trusts

Broadly speaking, non-dom settlors will no longer be personally assessed on the gains or foreign income of a non-UK resident trust unless they receive a distribution or benefit from the trust.

This treatment is also extended in certain circumstances to non-dom settlors who have become UK deemed domiciled (i.e. have been resident in the UK in 15 out of the last 20 UK tax years) as long as certain criteria are met. These trusts are known as 'protected trusts'. However, the 'protected' status of such a trust is easily lost and, once lost, cannot be reinstated. It is therefore essential that trustees take care not to inadvertently taint such a structure. If a trust is tainted, the settlor becomes subject to tax on all income and gains within the trust structure on an arising basis.

'Protection' is lost where:

- the settlor becomes UK domiciled under general law;
- the settlor adds property to the trust; or
- a settlement 'connected' with the settlor adds property (in this context 'connected' means another settlement also settled by the settlor or a trust of which the settlor is a beneficiary).

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Given the catastrophic consequences of even a small addition to a trust it is paramount that the rules are carefully observed and acted on in order for the beneficial treatment to continue.

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It should be noted that, based on HM Revenue & Customs' (HMRC) interpretation, gains arising on the disposal of certain non-UK funds, known as 'offshore income gains' may still be taxable on the settlor even if the trust has protected status and advice should be sought in these cases. In addition, income arising under the 'accrued income scheme' (whereby the element of sales proceeds representing accrued interest is taxed as income) may also still be taxable on the settlor.

Tainting

Adding property (also referred to as 'tainting') can occur in many ways. In particular, loans between the deemed domiciled settlor and their trusts can be problematic. In that situation tainting can occur where:

- the settlor makes a loan to the trust on non-commercial terms;
- the settlor takes a loan from the trust and pays excessive interest on that loan to the trustees;
- a pre-April 2017 uncommercial fixed term loan is not put on to a commercial footing at the end of the fixed term;

- interest on a loan is capitalised;
- interest due on a loan is not paid annually

Loans to/from an underlying company of the trust are similarly problematic.

There are other ways in which a trust can be tainted also, such as:

- the settlor adds property or increases the value of an asset held by the trust (one such example would be the waiving of dividends); or
- the settlor, who is the life tenant, fails to draw their income entitlement so that undrawn income stays within the trust.

There are exemptions from tainting which include the settlor:

- entering into arm's length transactions where there is no intention to confer a gratuitous intent, e.g. the settlor buys/sells from/to the trust on the same basis as a 3rd party;
- adds property or income pursuant to a pre-6 April 2017 commitment;
- adds property to pay expenses if the expenses exceed available trust income;
- fails to exercise a power of revocation. It is not clear however if failure to exercise other trust powers retained by the settlor would taint the trust; the settlor makes a loan to the trust on non-commercial terms;

There was a grace period until 6 April 2018 in which it may have been possible to restructure problematic loans to avoid tainting but this has now passed.

However, it may still be possible to reorganise loans where the settlor is not yet deemed UK domicile.

Valuation of benefits

The valuation of benefits provided from non-UK resident trusts has been put on a statutory footing. These apply to all UK resident beneficiaries and not just those who are non-dom or deemed domiciled. The changes are:

- Loans: the benefit of a loan equals the official rate of interest on the outstanding loan, less the amount of actual interest paid by the beneficiary. Interest has to be paid annually to reduce the amount of the benefit charged. Whilst the calculation of the benefit has not changed, what is different is that the beneficiary will now be treated as receiving a taxable benefit where the interest is rolled up even if the loan is on arm's length.

- Moveable property – art, yachts, jewellery, etc: the benefit is based on the value of the asset at acquisition at the official rate of interest, less any amount paid by the beneficiary. The beneficiary is taxed by reference to the number of days the asset was 'made available' to them. This can potentially amount to significant charges for beneficiaries.

- Land: there is no change in how this benefit is assessed, i.e. open market rent, less any amount paid by the beneficiary.

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How can we help

If you would like to discuss any of the above, please get in touch with your usual Blick Rothenberg contact or contact me directly using my details listed in the footer of this document.

Caroline Le Jeune
Partner
Private client
T +44 (0)20 7544 8986
E caroline.lejeune@blickrothenberg.com

Independent Member of BKR INTERNATIONAL

BLICK ROTHENBERG
a CogitalGroup company

16 Great Queen Street
Covent Garden
London WC2B 5AH

T +44 (0)20 7486 0111
E email@blickrothenberg.com
W blickrothenberg.com