CHARTER TAX

Helpsheet
UK Resident Beneficiaries of Offshore Trusts

There are a number of UK tax issues that trustees and UK resident beneficiaries of offshore trusts need to be aware of when considering distributions.

Different tax treatment may apply for UK beneficiaries who are not UK domiciled, compared to UK beneficiaries who are.

This helpsheet provides only an overview of the main areas that need to be considered and it should be noted that these rules are very complex, particularly where other areas of legislation come in to play.

We will be happy to provide more detailed UK tax advice based on the trust's and UK beneficiaries' particular circumstances and take no responsibility for action taken based purely on the overview provided in this helpsheet.

In the following narrative, any reference to "beneficiary" or "beneficiaries" means a UK resident beneficiary or beneficiaries, unless stated otherwise.

Distributions from Income

What is an "income distribution"?

Where a beneficiary has a life interest in the trust, they are entitled to the underlying trust income and, therefore, it is relatively simple to establish when trust income has been paid out to them.

Where they do not have a life interest, but instead the interest is discretionary, it can be more problematic to establish that a distribution received by a beneficiary is income, rather than capital. Tax case law provides the principle that it is necessary to look at the purpose of the distribution and the nature of the trustees' power being exercised. One must also consider the wording of the accumulation clause in the trust deed, with most of them directing that, once an accumulation has occurred, a subsequent distribution from accumulated income must be capital in nature. However, even though trust law may consider a distribution to be a capital one, the tax deeming provisions may disagree!

We will be happy to discuss this point further, if required.

How is the income distribution taxed?

Once it has been established that a distribution is one of income under trust law, if the beneficiary is UK domiciled, that income is normally taxable on the beneficiary (subject to the remittance basis).

Where the income is paid out as a result of the beneficiary having a life interest in the trust, the rates at which an income distribution is taxed are then determined by whether the trust is a "Baker trust" or "Garland trust", referring to two significant UK tax cases dating back to the late 1920s and early 1930s.

This note does not seek to go into a detailed explanation of the two types of trust, but we will be happy to provide further advice, if requested.

Suffice to say that, where the trust is a "Baker trust" and the income received includes dividend income, that dividend income is taxed on the beneficiary at the dividend tax rates (0% on the first £2,000, then 7.5%, 32.5% and 38.1%). All other income is taxed at the standard tax rates (20%, 40% and 45%).

If the income distribution is discretionary, the whole distribution is taxed on the beneficiary at the standard tax rates (20%, 40% and 45%).

Extra Statutory Concession ("ESC") B18

If the offshore trustees have paid tax on any of the income from which the distribution is made, the beneficiary can make a claim, under ESC B18, to get relief for some or all of the UK or foreign tax against their UK tax liability.

The ESC B18 claim is dealt with outside of the beneficiary's personal tax return, but is given as a credit on their self assessment statement.

To obtain relief under ESC B18, the trustees must provide details of the income arising, the UK or foreign tax that has been paid thereon, as well as copies of the relevant tax returns that have been submitted.

This information is provided by the trustees directly to HMRC Trusts, who will then liaise with the beneficiary's tax district to confirm the tax credit that is available.

If the beneficiary is not UK domiciled and the income distribution has been made to them offshore and not remitted to the UK, they can consider whether making a remittance basis claim will be beneficial. They will need to weigh up the cost of making the claim (loss of personal allowance and perhaps having to pay the annual remittance basis charge of £30,000 or £60,000) compared to the UK tax that would otherwise be payable on the income distribution.

If they choose not to claim the remittance basis, or they have remitted, they will be taxed in the same way as a UK domiciled beneficiary and will be able to make an ESC B18 claim, if applicable.

Distributions from Capital

What is a "capital distribution"?

A capital distribution is not only a payment made in cash (that is not an income distribution – see above), but can also be an *in-specie* transfer of a trust asset, an interest-free or low interest loan or allowing the beneficiary the use of a trust asset.

Where beneficiaries receive capital distributions from offshore trusts, or make use of assets owned by the trust at no cost, or low cost, to them, a UK tax liability may arise on that beneficiary.

Whether a UK tax liability arises – and at what rate it is taxable - depends on whether there is "net relevant income" or "stockpiled gains" within the trust structure.

"Net relevant income" is the income available after trust administration expenses have been deducted (so, in effect, what funds would actually be available to pay out), whilst "stockpiled gains" are the historic gains within the trust.

Calculating the value of the distribution

Where a cash or *in-specie* distribution is made, the value is, of course, simple to ascertain, being the value of the cash or asset distributed out.

However, where the beneficiary has use of a trust asset, or receives an interest-free or low interest loan, the position is not so straightforward and it is necessary to calculate the "benefit" arising.

Property (real estate) owned by the trust

Where the beneficiary has use of a property owned by the trust, either at no cost or reduced cost, the benefit is calculated as being the open market rental value of that property (reduced by any rent the beneficiary pays to the trustees).

Other trust assets

Where the asset is something other than real property (for example, the use of a car owned by the trust, or a painting hanging in the beneficiary's house), the benefit is calculated by applying HMRC's official rate of interest to, usually, the market value of the asset at the time it was acquired (less any contribution the beneficiary makes to the trustees for the use of the asset or to cover any repair, insurance, maintenance or storage costs for it). If the asset was not available to the beneficiary for the whole of the tax year, the benefit is apportioned accordingly.

HMRC review their official rate of interest at the start of each tax year. Currently the official rate of interest is 2.5%, but this may change on 6 April 2019.

Loans

Where a beneficiary is provided with an interest-free loan or a low-interest loan (i.e. that charges an interest rate lower than HMRC's official rate), the benefit is calculated by applying HMRC's official rate to the amount of the loan outstanding at the end of the relevant tax year. Alternatively, if the level of the loan has fluctuated over the tax year, interest can be calculated on a daily basis. Where the beneficiary has paid some interest, this is deducted from the benefit and, as before, if the loan is not in place for the whole of the tax year, the benefit is apportioned. If interest is paid, the withholding tax position thereon will require analysis.

Tax charge

Once the value of the benefit has been ascertained, it is then necessary to look at the trust's net relevant income and/or stockpiled gains to determine what the benefit should be matched to, with income always matched in priority to gains.

Where the beneficiary is UK domiciled, the benefit is declared on their annual tax return and, if matched to income, taxed at 20%, 40% or 45%.

If the benefit it matched to stockpiled gains, it is necessary to determine in what tax year those gains arose to the trustees, with a 10% surcharge being added to the usual 10% and 20% CGT rates for any gains more than 2 years old, up to a maximum surcharge of 12%, so a maximum potential overall rate of 32%.

Where the beneficiary is not UK domiciled and the distribution or loan has been made to them offshore and not remitted to the UK, there may be scope for them to make use of the remittance basis so that UK tax is not payable. This is also the case if such a beneficiary has use of a trust asset that is not situated in the UK.

Whether it is beneficial to claim the remittance basis will depend on the level of the potential tax on the benefit compared to the cost of making a remittance basis claim, such as loss of the personal allowance and annual exemption and whether the annual charge of £30,000 or £60,000 has to be paid.

If the beneficiary does not wish to claim the remittance basis, they will be taxed in the same way as a UK domiciled beneficiary.

What if the benefit is not fully matched to income or gains?

If there is insufficient net relevant income or stockpiled gains to match fully to the benefit arising in a particular tax year, any unmatched benefit is carried forward to be matched against any future trust income and gains. The benefit is only subject to UK tax in the hands of the beneficiary in the tax year in which it is matched.

In the same way, any unmatched income and gains within the trust are carried forward to be matched to benefits arising in future tax years and, again, taxed in the year of matching.

Motive Defence

Where the avoidance of UK tax was not the main purpose, or one of the purposes, for setting up the offshore trust structure, it may be possible to claim the motive defence to prevent the net relevant income within the trust being matched to trust distributions or benefits. However, no equivalent defence applies for trust gains.

This may, perhaps, be the case where, at the time the trust was created, the settlor was non-UK resident/domiciled and there were no UK resident beneficiaries and nor was it anticipated that there would be.

We will be happy to discuss this in more detail if you feel that this may be relevant to your circumstances.

Onward Gifting Rules

Perhaps unsurprisingly, there are extensive anti-avoidance measures in place to stop any attempts to circumnavigate these rules (which are, themselves, anti-avoidance in nature).

The most recent legislation change concerns a situation called “onward gifting” or “recycling”.

New rules were introduced from April 2018 to stop trustees making a distribution to a non-UK resident beneficiary that is then “onward gifted” to a UK beneficiary and that UK beneficiary not suffering a UK tax hit.

From April 2018, any such distribution that finds its way to a UK beneficiary will generally be treated as if it had been made to the UK beneficiary directly and matched to trust income and/or gains accordingly, unless there is a clear 3 year gap between the trust distribution and the “onward gift”.

Underlying Companies

Where the trust owns an underlying company (or companies), this adds a further layer of complexity to the structure and additional care must be taken to ensure that the UK tax rules are being complied with where there are UK resident beneficiaries.

We have not covered the further aspects here as they depend on the particular circumstances of each case, but will be happy to advise you in more detail on this, should it apply to you.

Failure to Correct

From 1 October 2018, new penalties were introduced where there is a failure to notify HMRC of any tax due where an offshore aspect is involved, giving them powers to charge penalties of up to 200% of the tax due, depending on the jurisdiction involved.

However, these can be reduced in certain circumstances, depending on how helpful and open the taxpayer is to resolving the issue.

What should I do now?

The rules surrounding UK taxation where offshore aspects are involved are growing ever more complicated. Therefore, it is quite possible for a beneficiary to have received a benefit from an offshore trust without the trustees or the beneficiary realising there is a UK tax issue.

We will be happy to assist by reviewing the position in detail and providing UK tax advice as to what action may need to be taken in respect of past transactions, as well as providing advice on any UK tax aspects going forward.

For more information, please contact **Janet Pierce** on **janet.pierce@charter-tax.com** or **Emma Cheeseman** at **emma.cheeseman @charter-tax.com** or call us on **+44 (0)20 7084 5771**.

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Taxation planning concerns the application of complex statute and case law to future events. Accordingly, however expert the opinion given, it is always possible that the Courts will take a different view of the application of the law.

We undertake to apply reasonable care and skill in the provision of advice. We do not guarantee that tax planning steps will in all circumstances achieve a certain legal effect.

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