AF1/J02
Part 5: Offshore Trusts

There always seems to be one question on offshore trusts, particularly in J02. The bad news is that it is an extremely complicated, the good news is that in either exam candidates will only be expected to know the basic principles.

J02 candidates should read the section on Residency and Domicile if they are not familiar with the recent changes that came into effect in April 2017.

The milestones for this part are to:

- Understand what is an offshore trust.
- Understand the basics of income and capital gains tax as they are applied to beneficiaries of an offshore trust.
- Understand the benefits of an Excluded Property Trust

What is an offshore trust?

A trust can be set up outside the UK and this can be advantageous for residents who are non-domiciled. In theory a trust could be set up anywhere in the world but in general the selected country should:

- Have a legal system that recognises the concept of a trust in a similar way to the UK.
- Be politically stable
- Offer a low or nil tax environment.

Just because the trust is based outside the UK does not mean it will be treated as an offshore trust. To qualify as an offshore (or overseas trust) all trustees must be non-UK resident. If one of the trustees is UK based AND the settlor was either UK resident or domiciled at any time when property was gifted into the trust, it will be treated as a UK based trust.

Many offshore trusts have a single corporate non-resident trustee to ensure the trust will always be treated as non-UK based.

An offshore trust can be a bare, interest in possession or a discretionary trust although the latter is the most common. It will have the same three parties as a UK trust, settlor, trustees and beneficiaries

It may also have another party, particularly if there is a corporate trustee, called the **Protector**. They are not usually trustees and don't hold trust property. Their role is to:

- Oversee the administration of the trust.
- Ensure the settlor's intentions are followed.
- Adjudicate in disputes between trustees

In addition they have the power to:

- Veto certain trustee decisions.
- Can remove or replace trustees

Taxation

Since an offshore trust is outside the scope of UK tax, HMRC have always been suspicious of them regarding them as a way of aggressive tax avoidance. They are not concerned if payments are made to a non-UK resident since they would not be liable to UK tax. On the other hand they are very concerned if they are used to try to avoid tax by making distributions to individuals who are resident and non-domicile.

Income and Capital Gains tax

An offshore trust will normally be set up by an individual who is resident but has non-domicile status. Any foreign income and gains will roll up tax free within the trust. UK source income will be taxed on the settlor as and when it arises.

The introduction of the 15/20 rule means that it is no longer possible to be permanently non-domicile so the government has introduced a concession. From April 6 2017 all existing and new trusts set up by a non-domiciled individual will be **"protected settlements"** and will retain this status even if the individual becomes deemed domicile. It will lose this status if property is added to the trust once the settlor becomes deemed domicile. Payments to the trust to cover any tax and administration fees when there is insufficient income in the trust to pay these can be made by the settlor without losing its protected status.

Foreign income and gains will only be taxable if they are paid to a resident beneficiary and can be matched with income or gains in the trust. From April 2018 a UK resident settlor will also be taxable on benefits received by a close family member anywhere in the world. This includes spouse, civil partner, cohabitee and minor children of the spouse or settlor.

Prior to 6 April 2018, tax could be avoided by making a distribution to non UK resident who then gifts it to a UK resident. The UK resident will now be taxed as if they had received a distribution directly from the trust if this gift is made within three years of it being paid to the non-resident.

Inheritance Tax

An offshore trust can be used to reduce the IHT liability of a deemed domicile individual.

An individual's liability is determined by their domicile

- UK Domiciles (including deemed domicile) are liable to IHT on worldwide assets
- Non-Domiciles are liable to IHT on UK assets

As any individual is deemed domicile once they are UK resident for 15 out of 20 tax years, this can create major issues.

> Pierre came to live in the UK in 2005. He only intended to work here for a short time but married Susan, an English woman. He regards the UK as his permanent home.
>
> He has UK assets of £900,000 but also French based assets with a value of £1.2m
>
> His current status is resident, non-domicile so only the UK assets will be subject to IHT. In 2020/21 he will be deemed domicile so his taxable estate will include the French assets.

This situation can be avoided by setting up an Excluded Property Trust whilst he is still non-domiciled.

Excluded Property Trust

The clue is in the title. Excluded Property is property that is excluded from the individual's taxable estate. In Pierre's case, his French assets are currently excluded property but it will lose that status from 2020/21.

Setting up an excluded property trust means that the property within the trust remains outside the settlor's estate even when they become deemed domicile.

The qualifying conditions are:

- The settlor must be non-domicile when the trust is set up and gifts are made
- The trust property must never have been in the UK
- Once the settlor has become deemed domicile, no further additions can be made into the trust.

A Former Domiciled Resident (FDR), that is someone who had domicile of origin but has since acquired domicile of choice could set up an EPT but it would be of little practical use.

> Rachel had UK domicile of origin but has lived and worked in Israel for many years and regards that as her permanent home.
>
> HMRC consider her to be non-UK domicile and she would not be subject to IHT on her Israeli assets. However, if she returned to the UK she would become UK domicile and any assets in the trust would be part of her UK estate. If she then left and returned to Israel the property would again be exempt.

The benefits of an EPT are:

- The trust will not be part of the settlor's estate even if they became deemed domicile.
- Transfers into the trust are not transfers of value because a non domicile is transferring non-UK assets to a non-UK recipient, the EFT trust.

- The settlor can be a beneficiary without it being treated as a Gift with Reservation
- If it is set up as a Discretionary Trust there will be no Periodic or Exit charges

The EPT in practice.

Whilst the trust property of an EPT can include cash, shares, and real property, as with a UK trust the investment of choice will often be an Insurance Bond. This must be non-UK based so it will probably be set up in the Channel Islands, the Isle of Man, the Republic of Ireland or Gibraltar. The original investment should come from a non-UK bank account. It will probably use a Discretionary Trust to give the greatest flexibility.

The beneficiaries can include the settlor, their spouse, children, grandchildren and further descendants including their spouse and civil partners. At the trustees' discretion, distributions can be made to any of these at any time.

That concludes this part so you should now understand:

- what is an offshore trust.
- the basics of income and capital gains tax as they are applied to beneficiaries of an offshore trust.
- the benefits of an Excluded Property Trust

Further Reading

https://www.gov.uk/guidance/non-resident-trusts

https://www.oldmutualwealth.co.uk/Adviser/literature-and-support/knowledge-direct/trusts/trust-taxation/excluded-property-trust/