



TAXguide 07/18

Deemed domicile changes – trust protections

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The questions and draft suggested answers in this TAXguide have been prepared by committee members of STEP, ICAEW, the CIOT and the Law Society to highlight and consider areas of uncertainty in the statutory provisions for trust protections as introduced by Finance (No 2) Act 2017 with effect from 6 April 2017. The questions and the draft suggested answers have been sent to HMRC for comment.

The draft suggested answers have not been agreed by or commented upon by HMRC at this stage and should not be taken as representing HMRC's views.

The draft suggested answers reflect the views of the committee members of the professional bodies involved in their preparation on the generic issues addressed in the questions and draft suggested answers. The questions and draft suggested answers are intended to assist professional advisers in considering the issues, 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.

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TAXguides are published by the Tax Faculty to provide practical guidance to tax practitioners on important developments to tax practice and policy.

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FOREWORD

Introduction

Finance (No 2) Act 2017 introduced very significant changes to the taxation of foreign domiciliaries.

An interim measure, introduced to assist foreign domiciliaries, with mixed fund accounts, who have been Remittance Basis users (whether automatic or as a result of making a claim) at least once between 2008/09 and 2016/17 inclusive, is cleansing. There is a two year window (6 April 2017 to 5 April 2019) during which cleansing transfers and the associated nomination can take place. The actual remittance of cleansed funds can happen at any time (so well outside of the two year window).

The legislation (found at Finance (No 2) Act 2017, Sch 8, Part 4 (reproduced in Appendix 1 to this legislation) is brief.

Initial HMRC Guidance was issued on 31 January 2018 (last updated 9 March 2018, reproduced in Appendix 2). This HMRC Guidance is aimed primarily at ordinary taxpayers.

These professional body questions and answers are intended to assist professional advisers.

Questions and draft suggested answers have been prepared by committee members of ICAEW, STEP CIOT and LSEW to highlight and consider areas of uncertainty in the statutory provisions, as introduced by Finance Act (No 2) Act 2017 with effect from 6 April 2017, for:

- cleansing of mixed funds ([TAXguide 05/18](#));
- rebasing and the changes to the CGT foreign capital losses election ([TAXguide 06/18](#))
- trust protections and other trust issues (this TAXGuide)
- the extension of IHT to overseas property representing UK property interests (not finalised yet)

The questions and the draft suggested answers have been sent to HMRC for comment.

Caveat

The draft suggested answers have not been agreed by or commented upon by HMRC at this stage and should not be taken as representing HMRC's views. We will update this TAXGuide when HMRC's comments have been received.

The draft suggested answers reflect the views of the committee members of the professional bodies involved in their preparation on the generic issues addressed in the questions and draft suggested answers. The questions and draft suggested answers are intended to assist professional advisers in considering the issues, 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.

SECTION A: PROTECTED FOREIGN-SOURCE INCOME AND TAINING

The description of what constitutes a protected trust and therefore what is protected foreign source income (PFSI) is set out in largely identical terms in TCGA 1992 Schedule 5 paragraphs 5A and 5B, ITTOIA 2005 sections 628A and 628B, ITA 2007 sections 721A, 721B and section 729A.

For the sake of brevity and convenience, the questions below refer to the TCGA provisions in Schedule 5 paragraphs 5A and 5B (unless otherwise specified in the question) but the same clarification should be regarded as asked and given in respect of the other provisions.

References to 'HMRC's guidance' in the questions below are to the guidance published by HMRC on 31 January 2018, as updated on 2 February 2018 available at: gov.uk/government

Question 1 – the point at which a settlement is created

The point at which a settlement is created by the settlor is important because in order to access the trust protections the settlement must have been created when the settlor was not deemed domiciled in the UK. How is the date of creation established?

Suggested answer:

There are no special rules for these purposes; the position under general law will establish the date of creation of the settlement. In general terms, assuming there is already certainty of objects and intentions, a validly constituted express settlement is created when property first becomes comprised in it. Until the settlement contains funds or other property it is not created. Mere execution of a document is not sufficient. It is necessary for the settlement to be properly constituted.

Question 2 – inadvertent additions

Can inadvertent additions of property or income taint a protected settlement?

Suggested answer:

Condition D is that 'no property or income is provided directly or indirectly for the purposes of the settlement by the settlor...' Property or income provided inadvertently would not by definition appear to be provided 'for the purposes of the settlement'. In addition an inadvertent addition of property or income would often also fall within the exemption in paragraph 5B(2)(b) for transactions without gratuitous intent.

Question 3 – de minimis disregard

It is unclear whether HMRC will be willing to apply a de minimis disregard but it would obviate the administrative burden of establishing evidence of intent or inadvertency. Such an approach would seem to be within HMRC's care and management powers and consistent with the limit that used to apply for foreign currency remittances (see CG78325).

Suggested answer:

HMRC would accept that where there is a de minimis amount, that amount is disregarded for Condition D unless it is part of an arrangement to provide property or income to the settlement in excess of the de minimis limit. The disregard HMRC will accept is the higher of £500 and 1% of the net value of the trust property.

Question 4 – settlement of which the settlor is a beneficiary – meaning of beneficiary

Condition D applies to property or income provided directly or indirectly ...by the trustees of another settlement of which the settlor is the settlor or a beneficiary. Is 'beneficiary' in this context restricted to an actual beneficiary or does it include any person capable of being added as a beneficiary?

In the latter case most settlements will have a wide power of addition so virtually any settlement from which the settlor is not specifically excluded could fall foul of this condition. As a matter of trust law unless and until someone is added they are not actually a beneficiary at all and the trustees do not need to consider whether to confer any benefits on them.

Suggested answer:

A 'beneficiary' in this context means an actual beneficiary of the settlement. HMRC accept that until a person is added as a member of the class of beneficiaries they are not a beneficiary.

Question 5 – meaning of 'provided'

For property or income to be 'provided' for the purposes of the settlement in Condition D, does there have to be 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)?

Suggested answer:

Yes, although the same point is made by the exclusions for arm's length transactions and transactions not intended to produce a gratuitous benefit.

Question 6 – does ongoing employment by the settlor taint a protected settlement

For the purposes of Condition D, the addition of value to property comprised in the settlement is to be treated as the direct provision of property for the purposes of the settlement (Schedule 5 paragraph 5A(7)). Assume that a protected settlement owns shares of a company in which the settlor is a senior employee. The shares contain the usual good-leaver / bad-leaver provisions, such that if the settlor leaves employment with the company then the shares are lost (either through forfeiture, conversion into deferred shares, change in share rights, sale back to the company, compulsory sale to other shareholders or some other similar mechanism). If the settlor is a 'bad-leaver' then the shares will be lost on disadvantageous terms (eg they may have to be sold back to the company for only £1).

Does the settlor remaining in employment – thereby preserving the value of the shares for the trustees – constitute an 'addition of value' to the settlement thereby causing the settlement to lose protected status?

Suggested answer:

No. The settlor remaining in employment merely preserves the value of the shares rather than adding to their value. However, even if there were some enhancement of the value of the shares, the use of the term 'provided' in Condition D indicates, as in other tax contexts, that there must be some element of bounty or gratuitous intent on the part of the settlor (see *IRC v Leiner* (1964) 41 TC 589). Typically, the settlor will wish to remain in employment for other reasons unconnected to the shares. Except in extreme cases (for instance where the employment is contrived and the overall terms of employment are not undertaken on a commercially justifiable basis), it is not thought that this would constitute the direct or indirect provision of property or income within Condition D.

Question 6a – share options or deferred shares

As above, save that the settlement owns shares under an American-style deferred shares plan (or alternatively owns options under a European-style option-scheme). Under the deferred shares plan, restrictions on the shares fall away as the shares 'vest'. Typically, this will be because the settlor remains in employment with the company in question. This more clearly 'enhances' the value of the shares. Does the answer to this question differ from the question above?

Suggested answer:

No. Although the settlor remaining in employment may enhance the value of the shares or options, as long as the overall terms of employment are undertaken on a commercially justifiable basis, this would not be considered to be the provision of property or income or the addition of value which disappplied Condition D. Only in extreme cases, where the settlor deliberately acted solely with the objective of enhancing the value of the shares or the share-option scheme was otherwise contrived to achieve this result, would this taint the settlement.

Question 7 – retention of income due to life tenant – does this constitute an addition?

What is the position where trustees of a life interest settlement simply retain income due to the life tenant who is the settlor? In such cases the trustees hold the income as nominee for the life tenant and there would not appear to be any question of property or income being provided within Condition D unless there is some positive act on the part of the life tenant which permits the trustees to retain the income.

Suggested answer:

Condition D is that no property or income is provided 'for the purposes of the settlement'. Income due to a life tenant who is the settlor will invariably leave 'the settlement' and become held on bare

trusts or nomineehip under TCGA section 60. So in a typical case where the trustees simply have not got round to making the distribution but they fully intend to, then the life tenant can be taken to have no gratuitous intent towards the settlement. However, where there is evidence that the life tenant has deliberately left income in the hands of the trustees with a view to the additional investment return enhancing the value of the property comprised in the settlement, Condition D may be in point.

Question 8 – guarantees and other transactions which do not add absolute value to a trust

Does an addition of value mean an addition of value in absolute terms, not relative terms i.e. the relevant question is not whether the transaction was beneficial to the settlement compared to some hypothetical commercial transaction, but whether the transaction itself resulted in an actual and identifiable increase in the value of the trust fund.

For example, assume trustees borrow commercially from a bank and pay an arm's length rate of interest. As is common, the bank requires 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.

Suggested answer:

Arguably there is no gratuitous intent on the part of the settlor in giving the guarantee as the settlor does not consider that there is any significant risk that the guarantee will be called (and even if it were the loan would be subrogated to the settlor assuming he has the right to recover any amounts he has paid under the guarantee from the trust fund).

SP5/92 takes the position on a generic basis that the giving of a guarantee is to be treated as the provision of property/income for the purposes of the settlement. However, in these particular circumstances, there is no provision of property or income to the trustees by the settlor merely by the giving of the guarantee. 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. Whilst a third party might have charged the trustees for giving a guarantee in similar circumstances, the guarantee does not itself increase the value of any of the trust assets. The transaction does not therefore fall foul of Condition D. Unless the guarantee resulted in the trust paying a rate of interest that was demonstrably uncommercial or there was a real risk of the trustees being unable to meet their obligations, HMRC would not regard the trust as tainted.

Question 9 – preserving the value of trust property rather than increasing it

A protected settlement owns a UK residential property in which the settlor lives. The settlor lives there rent-free by virtue of a licence granted by the trustees. The settlor generally keeps the property in good order and repair. Does this constitute an 'addition of value'?

Suggested answer:

No. Incurring expenditure of a revenue nature to maintain the property in good order and repair merely preserves the value of the property rather than enhancing it. Whilst it is not necessary, a requirement to keep the property in good order and repair could be included in the licence.

Question 9a – improvements to a property but with compensation

As above, but the settlor carries out significant improvements that would be categorised as capital in nature. However, the settlor is compensated for these improvements, either immediately or through some form of 'tenant-right' clause in the licence (entitling the settlor to compensation for improvements at the termination of the licence). Does this constitute an addition of value? Does the same apply if the tenant-right clause depreciates any improvements (for instance if the settlor spends £100,000 on improvements, the amount repayable under tenant-right will be written-off over the useful life of the improvement, say 10 years).

Suggested answer:

No. As long as the settlor is properly compensated for the improvements, then there is no addition of value to the settlement. A tenant-right clause, so long as structured on the same terms that would have applied with an arm's length tenant, can be sufficient to achieve this. Provided that any depreciation is on terms equivalent to arm's length terms it should not constitute an addition of value to the settlement. In the above example the settlor will enjoy the improved property while he or she still lives there. If however, the licence enabled the trustees to bring the settlor's occupation to an end at any time and they did so shortly after the improvements were made then HMRC would expect the settlor to be adequately compensated for such improvements.

Question 9b – saving the trustees an expense

As above, but the property is a block of flats (or other nearby properties). The settlor lives in one of the flats, but the others are let on arm's length terms to third party tenants. As the settlor lives nearby, he assists the trustees 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. But he does not do so on an overly regular basis, such as to make him a dependent agent of the trustees.

Does the position differ if the settlor lives nowhere near the property or properties, but fulfils the role which a managing agent would otherwise have fulfilled?

Suggested answer:

It is natural for a settlor or beneficiary to seek to assist the trustees to maintain the value of settlement property. Helping to maintain the value of the existing settlement is not the same as an addition of property, income or value (which contemplates value coming into the settlement 'from outside' it). Even if the trustees are thereby saved an expense, so long as this is through the settlor's own efforts, this would not appear to be an addition of value. The position would be different if the settlor met an expense which the trustees should properly have met (e.g. the settlor paid professional managing agents to save the trustees from doing so).

Question 10 – investment suggestions from settlor – addition of value?

The trustees of a protected settlement invest the settlement fund in a portfolio of financial investments. The portfolio is regularly reviewed both with professional investment advisers and with the beneficiaries (which may include the settlor). The settlor herself works in the finance industry (say a hedge-fund manager) and offers helpful advice to the trustees about the investment of the portfolio. The trustees accept this advice which results in a better return than would have been the case had the settlor not been consulted. Does this amount to an addition of property?

Suggested answer:

No. Trustees are typically under a duty to take into account the wishes and views of the settlor and other beneficiaries as part of the proper exercise of their role. So long as the investments are purchased at market value or otherwise on arm's length terms, the value added to the settlement is not by the settlor, even though the settlor may have recommended a good investment.

Question 10a – investment advice to trustees with additional features

As in question 10 above, but with one or more of the following additional features:

- (a) The settlor is a financial professional and routinely provides free advice, such that the trustees save on the fees which would otherwise have had to be paid to an independent financial adviser.
- (b) The settlor introduces the trustees to bespoke opportunities which would not have been available to the general public (but nonetheless the price paid by the trustees is market value or otherwise on arm's length terms).

- (c) The trust deed specifically reserves the role of “investment advisor” or “investment director” to the settlor and the trustees are obliged by the settlement deed either to consult the settlor or, in some cases, the trustees have no investment discretion at all and must follow the views of the settlor.

Suggested answer:

As in question 10, as long as all the investments are acquired at market value or otherwise on arm's length terms, there is no addition of property, income or value here. Any addition of value comes from the settlement fund being invested well, not from the settlor adding 'external' value. Introducing an 'opportunity' of itself should not amount to an addition of property. That the trustees are saved an expense by virtue of the settlor doing what any beneficiary or settlor would naturally do (namely aiming to work with the trustees to improve the investment of the trust fund) is not something that should be considered to be an addition of value. (By contrast, if the trustees are saved an expense for which they are liable, because the settlor pays that expense for them that would constitute an addition of value— see question 9b above).

Question 11 - reduced management fees or other preferential terms due to wider relationship with settlor

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

Alternatively lower fees are charged (or perhaps a higher return is given) because the settlor, in parallel, has his or her own funds with the same institution – and because both the settlor and the trustees are co-invested, the total investment moves into a higher tier.

A similar point arises where the investment fund is willing to charge reduced fees where the investment into the fund is made by an individual or an entity associated with that individual that the fund wishes to attract because of that person's 'name' in the market.

Suggested answer:

There is no provision of property or income, or addition of value to the settlement by the settlor. Whilst another investor might have been charged a higher fee in similar circumstances, the settlor has not provided any income or added value to the settlement. Condition D is not engaged.

Question 12 – addition of value by inaction – e.g. allowing an option to lapse

HMRC's published guidance includes the following example between paragraphs 5.4 and 5.5.

Example:

Raphael is domiciled under common law in British Columbia, where he was born and has his domicile of origin. He is the settlor of the Raphael 2007 Discretionary Trust. He is also a beneficiary of the trust. The settlement was made in March 2007 and the trustees are resident in the British Virgin Islands. The trust receives income that would be relevant foreign income if received by an individual resident in the UK. Raphael has been resident in the UK since July 2010. Raphael becomes deemed domiciled in the UK by virtue of his long-term residence in the UK with effect from 6 April 2025. Raphael holds an option to purchase a majority of the shares in a Canadian company, which are currently owned by the trustees of the Raphael 2007 Discretionary Trust, at a substantial discount to their present value. In June 2027 Raphael releases the option. At that time the exercise of the option would have allowed Raphael to acquire the shares at substantially below their market value. By forgoing the exercise of the option Raphael has increased the value of the shareholding of the settlement.

Conditions A to E are met, but it is necessary to determine whether or not the provision of property in June 2027 is to be ignored for the purposes of condition F. The release of the option by Raphael plainly does not fall within categories (c) to (g). It is not a transaction entered into on arm's length terms and Raphael does not offer any evidence that he had no intention to confer a gratuitous benefit on any other person. Neither category (a) nor category (b) allows the release to be ignored. Condition F is not met and the settlement is 'tainted'.

Would the outcome be the same if Raphael had merely let the options lapse?

Suggested answer:

Unless the lapse was caused by a non-tax related circumstance, eg the sudden ill health of Raphael which prevented him exercising the option thereby allowing it to lapse, the same outcome would flow. By analogy with IHTA 1984 section 3 where a transfer of value may be made by way of omission, an omission which results in the lapse of the option would be regarded as an addition of value.

Question 13 – property provided pursuant to a liability – timing.

If property is provided in pursuance of a liability incurred after 6 April 2017 but before an individual becomes deemed domiciled, it would be expected that Condition D would not apply as property would be treated as being provided when the liability to deliver is incurred. However, the disregard in paragraph 5B(2)(f) might indicate that property is provided when delivered not when the liability to deliver is incurred. How binding does the liability incurred prior to becoming deemed domiciled have to be? The example in the guidance does not make it clear.

Suggested answer:

Property is treated as being provided when the liability to deliver is incurred. The purpose of the specific disregard in Schedule 5 paragraph 5B(2)(f) is for the avoidance of doubt. The liability must be legally binding prior to becoming deemed domiciled even if it is conditional on certain events occurring.

Question 14 – income of intermediate companies in a chain – whether 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. Could it be confirmed that if the conditions of ITA 2007 sections 721A and 729A are otherwise met, income of all companies in the chain is PFSI.

Suggested answer:

It is agreed that the provisions in section 721A and section 729A regarding chains of companies must logically be construed so as to allow income received by companies at all levels in a chain to qualify as PFSI if the various other conditions in these sections are met.

Question 15 – 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 relevant transaction.

Read literally, this could mean that there are many circumstances where the income of such a company would not be PFSI for the purposes of the capital sum rules.

For example, if a settlor establishes an overseas investment company and transfers £10 million to that company before subsequently transferring the shares in the company to a 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 transfer of the £10 million to the company – these are different relevant transactions.

Is it accepted that, in these circumstances, the income of the company is PFSI within ITA 2007 section 729A(4) (assuming the other conditions are satisfied)?

Suggested answer:

the intention is that the income of an underlying company in these circumstances should be PFSI for the purposes of the capital sum rules to the extent of the trustees' interest in the company as a participator.

Therefore, if the company is wholly owned by the trustees and there are no external interests, it is accepted that the income qualifies as PFSI. This is on the basis of a purposive construction of section 729A(4)(e) so that the condition is treated as being satisfied as long as the income arises as a result of any 'relevant transaction' rather than the income having to arise as a result of exactly the same relevant transaction by which the trustees became participators in the company.

The position would however be different if, for example, the settlor had made a loan to the company as a result of which income arose to the company and the settlor retained the benefit of the loan. In these circumstances, the income of the company which was attributable to the loan would not be PFSI for the purposes of the capital sum rules.

This is because the series of 'relevant transactions' giving rise to the trustees' participation in the company is completely separate to the chain of 'relevant transactions' which results in income from the proceeds of the loan being received by the company. There is therefore no link between the relevant transaction resulting in the trustees becoming participators in the company and the relevant transaction giving rise to the income.

Question 16 – can existing loans be amended rather than replaced

A repayable on demand loan which was made directly or indirectly to a relevant settlement prior to 6 April 2017 on non-arm's length terms and which remains outstanding on that date will be regarded as a provision of property for the purposes of the settlement and therefore the trust protections will not apply if the settlor has become deemed domiciled. The transitional grace period alleviates the position, where the deemed domicile date is 6 April 2017 and the loan is either repaid in full together with any outstanding interest before 6 April 2018 or made subject to arm's length terms, and arm's length interest is paid to the lender for the period from 6 April 2017 to 5 April 2018 and continues to be payable in subsequent years.

In the interests of clarity, could it be confirmed that the existing on demand loan by the settlor that was not on arm's length terms need not be repaid and replaced with a new loan on arm's length terms, but that it is sufficient to satisfy the transitional provision if the existing loan becomes on arm's length terms by the introduction of new arm's length terms to the loan agreement?

Suggested answer:

There is no requirement to repay the loan and replace it with a new loan as long as the existing loan becomes a loan on arm's length terms as defined.

Question 16a

What is the position if a loan for a fixed term of say ten years repayable in 2026 was 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. However, if at the end of the ten year period the loan is not as such repaid (see paragraph 5.8 of HMRC's guidance) but put on arm's length terms as an on demand loan and the

official rate of interest is paid going forward does HMRC accept that no tainting arises? On one construction, TCGA 1992 Schedule 5 para 5B(5)(d) might suggest that if the loan becomes repayable after the deemed domicile date there is tainting even if it is immediately placed on arm's length terms.

Suggested answer:

As long as the loan is put on arms length terms at the end of the fixed term within the statutory definition then there is no tainting even if it is documented as a continuation of the existing loan rather than the making of a new loan.

Question 17 - loan terms backdated so interest-bearing at the official rate from the date on which it was made

Assume that a loan is made to the trustees of a settlement settled by a foreign domiciliary, either by the settlor or by another settlement of which he/she is a settlor or beneficiary, and the loan is made after the settlor has become deemed domiciled, and the loan is initially made on interest-free terms (or at a rate of interest which is lower than the official rate). This is likely to be due to ignorance of the draconian consequences of a loan being made on these terms. If, having been made aware of the issue, the parties agree that the loan should be treated as interest-bearing at the official rate from the date on which it was made, such that interest accrues from that date as if the loan had been interest-bearing at the official rate, and such interest is actually paid by the trustees at least annually, do HMRC accept that tainting will be avoided?

Suggested answer:

HMRC consider that if the loan terms are amended within the first year to make the loan interest-bearing at the official rate (or a higher rate), and interest is paid under the loan at least annually, and as a result of the amendment the amount of interest received by the lender in the year from the making of the loan is at least equal to the amount which would have been received in that period if the loan had been subject to interest at the official rate from the outset, then the loan should be treated as having been made to the trustees on arm's length terms.

Question 18 – payment of interest from trust to trust

Schedule 5 paragraph 5B (7) precludes an interest free loan left outstanding on 6 April 2017 from tainting inter alia if interest at the official rate is paid before 6 April 2018 in respect of the period from 6 April 2017 to 5 April 2018. In many cases the lender will be another trust. It is assumed that payment of such interest will not taint the lending trust.

Suggested answer:

In the circumstances described the lending trust will not be tainted.

Question 19 – loans to underlying companies - whether arm's length rules can apply.

It is not clear from the legislation that the requirement that no property or income is provided directly or indirectly for the purposes of the settlement extends to property or income so provided to companies owned by the non-UK resident trustees either wholly or in part.

However HMRC's published guidance (at 5.2) indicates that: 'When considering the tainting provisions it is also important to consider whether any property has been provided directly or indirectly by the settlor....to any underlying entities owned by the settlement at any time during the relevant period.'

Does it therefore follow from HMRC's view above that in the case of a loan to a company in which the settlement is a direct or indirect participator

- Schedule 5 paragraph 5B(2)(c) and 5B(2)(d) will preclude tainting where interest on such a loan at the official rate is payable and paid at least annually.

- Schedule 5B paragraph 5B(7) will preclude tainting where the loan is varied or repaid before 5 April 2018 if the conditions of paragraph 5B(7) are otherwise met.

Suggested answer:

HMRC's view is that that a loan to a company in which the trust is a direct or indirect participator can in principle constitute tainting in the same way that loans to trustees can. However, HMRC considers that the provisions of Schedule 5 paragraphs 5B(2)(c), 5B(2)(d), 5B(2)(e) and 5B(7) apply equally to loans made to companies as to loans made to trustees.

Question 20 – loans to companies whether arm's length terms are only those in paragraph 5B(8) or whether other ways in which such loans can be arm's length

Paragraph 5B (8) sets out what is necessary for a loan to be on arm's length terms if it is made by or to the trustees. Unfortunately, this paragraph does not, on the face of it, apply where a loan is made by or to a company which is owned by a settlement. On this basis, it seems open to a taxpayer to argue that any given loan is on arm's length terms as long as evidence can be produced to support this. For example, if it could be shown that a bank would have lent on similar terms.

However, this leaves settlors and trustees in a difficult position as, in many circumstances, it is very difficult to obtain evidence as to exactly the terms on which a bank may be prepared to lend and it would be much simpler both for taxpayers and for HMRC if it could be accepted that, in the absence of any such evidence, the statutory arm's length provisions in paragraph 5B (8) would apply to loans to or from a company owned by a trust as well as loans to or from the trustees.

Suggested answer:

It is accepted that, for the purposes of Condition D in paragraph 5A (and the equivalent income tax provisions), a loan by or to a company or other entity owned by a trust will be treated as being on arm's length terms if it complies with the provisions of paragraph 5B (8). It is also accepted that a loan which does not satisfy these conditions is on arm's length terms if HMRC are satisfied that this is the case based on any evidence provided.

Question 20a

If a loan or other transaction is entered into between the trustees and a company wholly owned by the trust or vice versa, is Condition D in point?

Suggested answer:

No, Condition D is not contravened by a loan or other transaction between entities within a wholly owned structure even if value passes from one entity to another.

Question 21 – change in official rate of interest

HMRC's guidance indicates that a loan is on arm's length terms if the interest rate is equal to the official rate at the date the loan is entered into (see the examples under category (c) and category (d) in paragraph 5.5 of the guidance). It is not however clear whether:

- (a) it makes any difference whether the loans are for a fixed term or whether they are repayable on demand; or
- (b) HMRC will also accept that the loans are on arm's length terms if, in fact, the terms of the loans provided for the interest rate to be varied so as to track the official rate from time to time.

Suggested answer:

Provided that the interest rate is equal to the official rate at the date of the loan, it makes no difference whether the loan is for a fixed term or repayable on demand. HMRC also accepts that the loan is on arm's length terms if the interest rate is at the official rate at the date the loan is entered into and the loan agreement provides that thereafter the interest rate will track the official rate from time to time.

Question 22 – 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. Will the use of these separate rates be accepted as on arm's length terms in respect of loans denominated in these currencies ?

Suggested answer:

Regardless of whether it is higher or lower, the use of the special rates for Japanese yen and Swiss francs is an alternative to the official rate that parties to a loan in those currencies will be free to adopt without the trust being tainted. However, in these circumstances the normal official rate can also be used.

Question 23 – inability to vary terms of loan due to external shareholders

There are situations where trustees own an interest in a company, but do not have full control either because the interest is a minority issue or the interest is a majority one but the level of control is affected by the existence of significant minority shareholders. In such cases, shareholders' agreements (either entered into when investors put funds into a business, or sometimes imposed by the courts in divorce cases) may require the consent of the other shareholders if the terms of loans from the settlor to the company are amended. In such cases, consent may not always be forthcoming – in particular where the arrangement has resulted from acrimonious divorce proceedings, or where the company's business does not have the cash to pay the interest.

How will the tainting rules apply in such cases , where it has not been possible to amend the terms of the loan, due to circumstances outside the control of the settlor, so that it is on arm's length terms by 5 April 2018.

Suggested answer:

There is no gratuitous intent on the part of the settlor if a pre-existing shareholders' agreement or other arrangement which is binding on the shareholders prevents any change to the terms of a loan (absent a breach) without shareholder consent where such consent is sought in accordance with the terms of the agreement and denied on valid grounds, provided that that the shareholders are not otherwise connected. The lack of gratuitous intent in these particular circumstances means that no property or income is provided for the purposes of the settlement by the settlor and Condition D does not apply. An extension of the loan beyond its fixed term on non-arm's length terms would fall within Condition D.

Question 24 – use of funding bonds to pay interest; receipt and re-lending of interest

In some cases, companies which are controlled by a settlement may not have funds available to fund interest payments. In cases where the company has a portfolio of liquid investments, it should be possible to realise some of those investments to pay the interest on loans from the settlor (or a connected trust) on arm's length terms. However, where the underlying company has a more active business, or has a portfolio of illiquid investments, it may not be possible for the company to find sufficient cash to fund the interest payments.

Assuming that the settlement will be tainted if interest remains unpaid in these circumstances:

- Would the issue of a funding bond¹ (even if this is not foreseen in the loan documentation) be regarded as payment for these purposes, and so avoid the trust being tainted. The issue of the funding bond in this case should mean that the interest is treated as paid, and so is taxable on the settlor.

¹ A funding bond is defined in ITTOIA 2005 section 380(3) as including 'any bonds, stocks, shares, securities or certificates of indebtedness (but does not include any instrument providing for payment in the form of goods or services or a voucher'. It will usually be a loan note (although it can be shares). It would be possible either for a funding bond to be issued under the terms of the original loan instrument or as part of a separate side agreement between the parties. Under section 380 (2) the issue treated for income tax purposes as if it were the payment of so much of that interest as equals the market value of the bonds at their issue.

- Will the interest be treated as paid in a case where it is paid and then immediately loaned back to the company on arm's length terms, and the settlor treats the interest as having been received by them and taxed accordingly.

Suggested answer:

Provided that the arrangements for payment of interest on arm's length terms result in the settlor as lender being in receipt of interest income for UK tax purposes, the arrangements described will not fall foul of Condition D. Loans from persons other than the settlor (other than a trust where he is the settlor or beneficiary) would not taint the trust as such although may, depending on their particular terms, raise other tax issues in relation to that lender.

Question 25 – indirect provision of property/income or addition by a company owned by the settlor

Would the indirect provision of property or income or an addition of value by a company owned by the settlor mean that Condition D is not met ?

Suggested answer:

Yes, the indirect provision by a company owned by the settlor will be treated as the provision of property or income by the settlor in the same way as a settlor transaction. Therefore a loan by a company owned by the settlor will taint the trust unless made on arm's length terms.

Question 26 – failure to reclaim 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.'

What is the position if the recoverable tax was paid before 6 April 2017, in some cases many years before ?

Suggested answer:

If, prior to 6 April 2017, a reasonable time has passed since the right of reimbursement first arose Condition D will not apply. 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.

Question 27 – inheritance tax implications of loan interest payable at the official rate

Paragraph 5B(8) sets out the circumstances where a loan is considered to be on 'arm's length terms'. These provisions are repeated in the equivalent income tax provisions. However, there are no comparable inheritance tax provisions, which may produce uncertainties in some circumstances. For example, assume that trustees make a ten year fixed term loan to a UK resident settlor at a rate that does not exceed the official rate of interest. Further assume that a bank would charge interest at a rate that exceeds the official rate of interest in such circumstances. The settlor cannot pay a higher rate without tainting the settlement. In such circumstances is it accepted 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. As a result there will be no possibility of an exit charge under IHTA 1984 section 65.

Suggested answer:

HMRC does not intend to trigger inheritance tax liabilities and reporting requirements as a result of settlors and trustees complying with the statutory provisions under the anti-tainting provisions that treat the provision of loans and payment of interest as being under arm's length terms under those rules.

SECTION B: BENEFITS CHARGE ITA 2007

Sections 731 AND 732; TCGA 1992 ss97B and 97C and equivalent income tax provisions

These sections charge benefits to income tax and have since 6 April 2017 been extended to the transferor unless he is domiciled in the UK under general law or is deemed UK domiciled as a returner.

Question 28 – reimbursement of tax – benefit for transfer of assets (ToAA) abroad code ?

ITTOIA 2005 section 646 specifically gives the settlor the right to reclaim from the trustees tax payable by the settlor under ITTOIA 2005, sections 624 or 629. Where the settlor does not do so HMRC consider that this could be a transfer of value for IHT purposes on the part of the settlor (see SP5(92)) and unless a genuine attempt to enforce the right to reclaim has been made that it could taint the trust (see 5.3 and 5.5 of HMRC's guidance). As such, it is assumed that HMRC would agree that the reimbursement to the settlor of the tax suffered should not be seen as a benefit under the new transfer of assets abroad benefits charge.

To take an example:

If a UK resident foreign domiciled settlor establishes a family trust mainly for the benefit of children but being cautious is amongst the beneficiaries (just in case she needs to request funds) then ITTOIA 2005, section 624 is in point. Tax for 2015/16 and 2016/17 is suffered by the settlor on the trust income and, in line with ITTOIA 2005, section 646, reimbursed to her by the trustees in 2017/18. Does HMRC accept that this is not a benefit under the new transfer of assets abroad (ToAA) ITA 2007, section 731 charge?

It is assumed that HMRC does accept that the reimbursement does not give rise to negative income tax or CGT consequences, since:

- Firstly, including a right to reimbursement of the tax in the legislation and then making it taxable would be odd.
- Secondly, since HMRC consider that there will be a transfer of value where the settlor makes no effort to be reimbursed it suggests that HMRC must see the reimbursement as the satisfaction of a right of the settlor and not the obtaining of a benefit (or a capital payment). It would not be fair to, on the one hand, subject the settlor to IHT if the tax suffered is not reimbursed and on the other, if it is reimbursed look to impose an income tax or CGT liability.
- Thirdly, in the HMRC Capital Gains Tax Manual at CG38625 <https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg38625> it states at the end that for CGT purposes there will be no capital payment where a beneficiary or settlor receives an amount under a statutory right for reimbursement (such as ITTOIA 2005, section 646). Taking a different approach for the adjusted ToAA benefits charge would not make sense.

Suggested answer:

HMRC accepts that where a beneficiary or settlor receives an amount under a statutory right of reimbursement (such as ITTOIA 2005, section 646) that it will not be seen as a benefit for the purposes of the ToAA benefits charge legislation, so there will be no negative income tax consequences.

Question 29 – meaning of ITA 2007 section 731(1A)

Section 731(1A) prevents a charge where the recipient is non-resident when he/she 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. At a purposive level section 731(1A) is plainly 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. Could it be confirmed that section 731(1A) will 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.

Suggested answer:

It is not the intention to widen the scope of the transfer of assets provisions by visiting charges on non-resident transferors/settlors (or indeed on non-resident family members themselves). The policy intent of this provision is to ensure the charge under section 733A on the settlor/transferor is not frustrated by the fact that the actual recipient of the benefit is non-resident. HMRC's view is that the non-resident individual cannot themselves be subject to tax whilst non-UK resident. More particularly, if payments are made to the settlor after that settlor has become non-resident it is not intended to charge the settlor.

Question 30 – further territorial issues with the change to the ToAA provisions

As a consequence of the amendments to ITA 2007, sections 731, 732 and 733 ITA, it appears that a benefit, provided to a non-UK resident under a power to distribute capital, may be matched and treated as income under section 732. However, due to the restrictions in section 731(1A), only a certain narrow class of non-UK resident individuals may actually be subject to UK tax on that income (none if the purposive approach in the answer to the question above is applied).

The concern is that whilst most non-residents are clearly not taxed on the matched income, the fact that the benefit appears to be matched under section 733 (even though the recipients are non-UK resident) could be taken to mean that capital payments that are thought to be matched to TCGA 1992, section 87 trust gains in the run up to 6 April 2018 will not be so matched.

The reason for the concern is TCGA 1992, section 97(1):

- (1) In sections [86A]1 to 96 [and Schedule 4C]2 and this section "capital payment"
 - (a) means any payment which is not chargeable to income tax on the recipient or, in the case of a recipient who is [not resident]5 in the United Kingdom, any payment received otherwise than as income, but
 - (b) ...

Section 97(3) goes on to state:

The fact that the whole or part of a benefit is by virtue of [section 733 of ITA 2007]4 treated as the recipient's income for a year of assessment after that in which it is received—

- (a) shall not prevent the benefit or that part of it being treated for the purposes of sections [86A]1 to 96 [and Schedule 4C]2 as a capital payment in relation to any year of assessment earlier than that in which it is treated as his income; but
- (b) shall preclude its being treated for those purposes as a capital payment in relation to that or any later year of assessment.

It could be inferred that a benefit received by a non-UK resident which is matched to income under ToAA is not a 'payment received otherwise than as income' for the purposes of section 97(1). In which case, the benefit would not be a capital payment for section 97 purposes and so would not be matched to stockpiled gains.

This does not however appear to be right. Where a capital payment is made to a non-resident, the question is whether the payment is of an income or capital nature under normal trust law principles. This is confirmed in HMRC's manual (CG 38625). The reference in TCGA section 97(3) to income being treated as arising under ITA section 733 must therefore be read as only applying where that

income is taxable (or potentially taxable) – i.e. where the beneficiary is UK resident or is a close family member of a UK resident settlor.

This is relevant only for the 2017/18 tax year since the current Finance (No. 2) Bill will when enacted as Finance Act 2018 change the rules such that capital payments to non-UK residents cannot be matched post 5 April 2018.

Suggested answer:

The purpose of section 97(3) is to prevent a CGT charge where a capital payment is subject to income tax under the transfer of assets abroad benefits charge. For the purposes of section 97(1) HMRC agree that a benefit paid to a non-UK resident which is matched to income under ToAA is a payment otherwise than as income for 2017/18 and so is a capital payment and can be matched to gains unless the beneficiary is a close family member of a UK resident settlor.

Question 31 – ITA 2007 section 731(1A) – FIFO and income before 5 April 2017

The charge under section 731(1A) is only made if the relevant income matched to the benefit is PFSI (see section 721(3BA)). Two points arise:

- (a) In determining which relevant income is matched to the benefit is it correct that FIFO must be used by virtue of ITA 2007 section 735A ?
- (b) Is it the case that relevant income cannot be PFSI unless it arose after 5 April 2017 ?

Suggested answer:

In relation to (a) it is clear from section 731(1A) that section 735A is applied and therefore FIFO is to be used. For (b) 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.

Question 32 [text to follow]

Question 33 – valuation of benefits on movable property

The new rules contained in Schedule 9 of F(No 2) A 2017 on valuation of benefits raise some practical issues. The valuation of benefits on movable assets in TCGA section 97B (and equivalent income tax provisions) are reasonably clear in relation to art but are more difficult in relation to items such as planes and yachts. The issues apply not just in relation to settlors but beneficiaries more generally.

Example:

X as beneficiary has exclusive free use all year of a private plane owned by the trust. The cost of the plane to the trust was £25 million. The annual taxable benefit is therefore currently £625,000 ignoring 'T' in the legislation. The trustees (or underlying company) require X to reimburse them in full for the crew of the plane who include an air hostess as well as two pilots. X also pays all repairs, insurance and storage charges but no other payments. The total cost of this is £700,000 pa. In these circumstances does HMRC accept that there is no taxable benefit on X and furthermore that if the payments for the plane do not exceed an arm's length amount no tainting occurs if X is the settlor and the trust is a protected trust?

Suggested answer:

As X has exclusive use of the plane, any costs or expenses reimbursed to the trustees, whether they relate to crew or other costs, are in respect of the availability of the plane. Therefore there is no benefits charge and no tainting if the payments are no more than would be paid on arm's length terms.

Question 34 – methodology of valuation

In some cases the arm's length payment for use of a particular asset or house may be more or less than the deemed value of the benefit set out in TCGA 1992 sections 97B and 97C. For example, a beneficiary may occupy a house on a ten year lease at full market rent and as a condition of the lease has to pay for all improvements and maintenance. The arrangement reached is fully commercial with independent valuations.

In these circumstances the market rent due may often be less than that paid under an assured shorthold tenancy where the tenant is not generally liable to pay for improvements and the tenancies are shorter. It is assumed that in these circumstances the provisions in Schedule 9 are intended to displace any actual arm's length arrangements. Therefore if the rent being paid on a commercial basis under a ten year repairing lease is less than the rental value as defined in section 97C(3) (which assumes that the landlord bears the cost of repairs) a taxable benefit will still arise.

Suggested answer:

This is correct. However, the beneficiary will be able to deduct from the taxable benefit any sums actually paid in rent for the availability of the land (see section 97C(1)(b)(i)) and any costs of repair, insurance or maintenance (but not improvement). (section 97C(1)(b)(ii)).

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