

OFFSHORE TRUSTS AND FINANCE ACT 2008 - ALL IS NOT LOST!

INTRODUCTION

With the dust still settling on the Pre-Budget Report 2009, a largely uneventful Budget for offshore trustees, we look back at the sweeping changes introduced to the taxation of non-UK resident trusts in Finance Act 2008. Although many offshore trustees and UK resident but non-UK domiciliaries may still be reeling from the effect of the new rules, we highlight some opportunities to mitigate the impact of the changes – and find a number of reasons to be cheerful.

NON-UK RESIDENT TRUSTS AND FINANCE ACT 2008 - A REMINDER

Although a detailed analysis of Finance Act 2008 (“FA 2008”) is beyond the scope of this newsletter; for the present purposes it is sufficient to remind ourselves that from 6 April 2008, as a general rule UK resident but non-UK domiciled individuals (“RNDs”) are now subject to capital gains tax if they receive a “capital payment” from a non-UK resident trust which is “matched” against gains realised by the trustees. A “capital payment” includes a capital distribution, but also includes a benefit such as an interest-free loan received from the trustees or rent-free occupation of a property held by the trustees. A RND beneficiary, however, who claims the remittance basis will only be taxable on the matched trust gains if he remits the capital payment to the UK.

REASONS TO BE CHEERFUL - PART ONE

Despite the changes, FA 2008 contained a number of provisions which mitigate the effect of the new rules. In particular, under transitional provisions contained in FA 2008, capital payments received by a RND beneficiary after 5 April 2008 will not be taxable when matched against gains realised by the trustees before 6 April 2008. The position can be further improved if the trustees make a “rebasing election” (see below).

REASONS TO BE CHEERFUL - PART TWO

The transitional provisions mentioned above will by now be familiar to many. A closer look, however, at how the new rules operate in practice, reveals some further redeeming features which (whether intentionally or otherwise) potentially make the new rules less menacing than they at first seem.

The planning opportunities that are available derive mainly from the reversal of the matching rules from “first in first out” (“FIFO”) to “last in last out” (“LIFO”). Prior to 6 April 2008, capital payments were matched against trust gains on a FIFO basis. This meant a capital payment received by a beneficiary in a tax year was matched against gains realised by the trustees in earlier tax years before being matched against gains realised in more recent tax years. Since 6 April 2008, gains are now attributed to capital payments on a LIFO basis. This means that a capital payment received by a beneficiary is now matched against trust gains realised in the most recent tax years first (starting with the tax year in which the capital payment is received and working backwards). Any surplus capital payments are then carried forward to be matched against gains realised in future tax years.

The planning opportunities that present themselves as a result of this change are summarised below. This, however, is a complex area where there are traps for the unwary. Proper advice will therefore be essential to ensure successful implementation.

- **Mitigating the “supplementary charge”**

Where a settlement contains accumulated unmatched gains, the rate of capital gains tax payable by a beneficiary who receives a capital payment may be increased due to the “supplementary charge”. This is the increased rate of tax that applies where there is a delay between gains being realised and distributed. Since 6 April 2008, the standard rate of 18% is increased by 1.8% for each tax year in which gains remain unmatched, up to a maximum rate of 28.8% after six tax years.

The reversal of the matching rules is generally beneficial since it mitigates the effect of the supplementary charge. This is because more recent gains are now matched before older gains (which may be taxed at a higher rate once the supplementary charge has been added). Nevertheless, it remains tax efficient for trustees to avoid accumulating stockpiled gains and advisable (subject of course to non-tax driven factors) for trustees to distribute gains in the tax year in which they are realised.

- **Rebasing elections**

The LIFO order of matching may be less beneficial when viewed in conjunction with the transitional provision which provides that capital payments received by a RND beneficiary after 5 April 2008 will not be taxable when matched against gains realised by the trustees before 6 April 2008. For example, if a capital payment is received by a RND beneficiary in the current tax year (2009/10), it will be matched against gains realised after 5 April 2008 (which are taxable) before being matched against gains realised before 6 April 2008 (which are not taxable). The result is that only once the post-5 April 2008 (taxable) gains have been used up will the pre-6 April 2008 (non-taxable) gains become available.

Nevertheless, the potentially adverse effect of the LIFO rule may be mitigated if the trustees make a rebasing election. If a rebasing election is made, even though gains realised after 5 April 2008 will be matched first, only the post-5 April 2008 element of those gains will be taxable; with the increase in value prior to 6 April 2008 being effectively ignored. Considering that asset values have generally not yet risen significantly since 5 April 2008, in many cases the amount of the post-5 April 2008 gain may be small or non-existent.

- **Clearing out stockpiled gains – now is the time**

Clearly, as asset values start to recover, further gains may be realised by the trustees and any further capital payments to RND beneficiaries will be taxable with reference to those gains in priority to gains realised prior to 6 April 2008.

Therefore, if a settlement contains significant stockpiled gains which were realised prior to 6 April 2008, it may be beneficial to make capital payments to RND beneficiaries sooner rather than later before significant further gains are realised. This will allow the pre-6 April 2008 (tax-free) gains to be matched before further (taxable) gains are realised.

- **Making the most of the remittance basis – distributions outside the UK**

Where gains have already been realised since 5 April 2008 (or further gains are realised in the future), capital payments can be made to RND remittance basis users outside the UK (and not remitted) to wash out any post-5 April gains without a tax charge. Once the post-5 April 2008 gains have been fully matched, further capital payments can be made to beneficiaries in the UK to match against any pre-6 April 2008 gains.

A similar technique is available where a capital payment has been received in the UK in the tax year 2008/09 or later and a gain is then realised in the same or a later tax year. In these circumstances, it is possible to avoid (or reduce the amount of) the gain being matched against the UK capital payment if a further capital payment is made outside the UK (and not remitted) in the tax year in which the gain is realised. Although in this situation tax will generally only be deferred (since any unmatched part of the UK capital payment will be carried forward to be matched against future gains); tax can potentially be avoided completely if the settlement is wound up while the capital payments remain unmatched.

- **Selling trust assets**

Where capital payments have been received in the UK after 5 April 2008 and the trustees own several assets standing at a gain and the gain on some of those assets accrued mostly pre-6 April 2008 while the gain on other assets accrued mostly post-5 April 2008, tax can be mitigated if the trustees sell the assets on which the gain accrued mostly pre-6 April 2008 and make a rebasing election. The pre-6 April 2008 gain will not be taxable when matched against the UK capital payment. If the trustees then sell the assets on which the gain accrued mostly post-5 April 2008 in a following tax year, these can be washed out tax-free if further capital payments are made to remittance basis users outside the UK and not remitted. The converse applies where post-5 April 2008 capital payments have been received outside the UK and will not be remitted.

- **Rent-free occupation of houses – tax free as well?**

Under the new rules, rent-free occupation of a UK property by a RND will give rise to ongoing capital payments which will be taxable as soon as gains are realised – whether on the sale of the property or (if other assets are held within the trust) on the sale of other investments by the trustees. In other words, even in a classic “dry trust” where the UK property is the only asset held by the trust, there is now a tax time-bomb which goes off once the property is sold and the accumulated capital payments are matched against the profits from the sale.

It might be assumed that the only ways of avoiding this time-bomb are either for the beneficiary to start paying a market level of rent or for the trust to be wound up. With careful planning, however, it should be possible for the property to remain in a dry trust and for the beneficiary to continue to occupy the property rent-free, while avoiding (or at least reducing to a negligible amount) the eventual capital gains tax charge by taking advantage of the LIFO rule. Please contact us if you would like further information about this planning.

CONCLUSION

The impact of the changes to the taxation of offshore trusts as a result of FA 2008 has been significant. The complexity of the new rules is such that detailed advice is essential in order to successfully navigate through the new legislation and avoid inadvertent tax liabilities. There are, however, a number of ways in which the effect of the changes can be tempered – ultimately ensuring that offshore trusts continue to provide an extremely useful tool for RNDs to structure their wealth and pass wealth down to the next generation more efficiently.

This article offers general guidance only. It reflects the law as at February 2010. The circumstances of each case vary and this article should not be relied upon in place of specific legal advice.

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