The UK tax treatment of offshore trusts

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1. Introduction

1.1 Trust taxation in the United Kingdom

The offshore trust has proved a popular tool for financial planning in the United Kingdom – not only to minimise the incidence of UK tax on income, gains and assets, but also to provide financial security for the settlor's family. Over the last 40 years, the United Kingdom has developed extensive anti-avoidance legislation targeted at offshore trusts to ensure that UK income tax and capital gains tax cannot be avoided using offshore trusts. Such trusts, however, can still afford tax-planning benefits, particularly for those domiciled outside the United Kingdom.

1.2 Offshore trusts

The term 'offshore trust', although not legal or statutory, is universally used to denote a trust that is resident outside the United Kingdom, usually but not necessarily in a low-tax jurisdiction. In this chapter, the terms 'offshore trust' and 'non-resident trust' are used interchangeably.

1.3 Domicile

An individual's domicile status is important for UK tax purposes, particularly in relation to offshore trusts. This is the case for both settlors and beneficiaries, even after becoming deemed domiciled in the United Kingdom.

1.4 Deemed domicile

From 6 April 2017 an individual who has been resident in the United Kingdom for 15 of the previous 20 tax years is deemed to be domiciled in the United Kingdom for all tax purposes. For inheritance tax, at least one of the previous three years or the current year must also be a year of residence, allowing those with a foreign domicile who leave the United Kingdom to lose their deemed domiciled status in their fourth year of non-residence.

Deemed domicile also applies to a non-domiciled individual with a UK domicile of origin who was born in the United Kingdom, if he or she becomes UK resident, known as a 'formerly domiciled resident'.

Prior to 6 April 2017, deemed domicile applied only for inheritance tax purposes, taking effect for those resident in the United Kingdom for at least 17 of the last 20 years.

Deemed domicile for inheritance tax is also attributed to an individual who has given up his or her UK domicile within the previous three years.

1.5 The remittance basis

Individuals who are resident but not domiciled in the United Kingdom will be liable to UK tax on all UK-source income arising and capital gains realised, but in respect of foreign income (known as relevant foreign income) and gains may elect annually to be liable to UK tax only to the extent that it is remitted to the United Kingdom.

From 5 April 2008, long-term UK resident taxpayers aged 18 or over are subject to the remittance basis charge on the making of such a claim. A long-term UK resident taxpayer is an individual who has been resident in the United Kingdom for at least seven out of the nine years preceding the year of claim. The rates of remittance basis charge (for 2019?2020) are as follows:

Years of residence	**Remittance basis charge**
7 of the preceding 9	£30,000
12 of the preceding 14	£60,000

Where an individual's unremitted foreign income and gains for a year are less than £2,000, no claim is required and the remittance basis will apply automatically. In addition, a claim is not required if an individual has no UK income or gains and remits no relevant foreign income or gains, provided that he or she is not long-term UK resident or is under 18 years of age at the end of the year.

From 6 April 2017 an individual who is deemed to be domiciled in the United Kingdom is no longer able to choose to be taxed on the remittance basis.

Under the remittance basis, foreign income and gains are treated as remitted to the United Kingdom and taxable on an individual if they are brought to, or received or used in, the United Kingdom by or for the benefit of a relevant person. The definition of a 'relevant person' is very wide and includes not only the individual, but also:

- his or her spouse (including co-habitees);
- minor children and grandchildren (and those of his or her spouse);
- closely held companies in which a relevant person is a participator;
- trustees of a settlement of which a relevant person is a beneficiary; and
- a body connected with such a settlement.

A remittance can occur not only through the direct transfer of the income to a UK bank account, but also by bringing an asset acquired with foreign income to the United Kingdom, or using foreign income to pay interest or to repay the capital of a loan offshore relating to UK property or services.

1.6 Residence of trusts

Strictly speaking, a trust does not have a residence, since it is not a separate legal person in its own right. However, it is a convenient legal fiction to which even the legislation resorts, and one needed for the purposes of this chapter.

It is the residence status of the trustees, and not that of the settlor or beneficiaries, that determines whether a trust is an onshore trust or an offshore trust. The residence and domicile status of the settlor and beneficiaries plays a key role, however, in determining how the trust income and gains are taxed.

Historically, there was no single definition of 'residence' that applied to trustees across all taxes. However, since 6 April 2007 the definitions for income tax and capital gains tax have followed the existing income tax definition, which is enacted as Section 475 of the Income Tax Act 2007.

(a) Income tax

From 6 April 2007, for income tax purposes, trustees are treated as if they were a single person, distinct from the persons who are the trustees of the settlement from time to time. To determine the residence of that person, the general rule for residence of individuals (or of companies for a corporate trustee) must be applied to each trustee in turn. One of three situations will apply:

Residence status of trustees	Residence status of trust
All UK resident	UK resident
All non-UK resident	Non-UK resident (ie, offshore)
Mixed	Depends on status of settlor

A trustee is deemed to be UK resident, for the purpose of this test, where he or she acts as a trustee in the course of a business carried on in the United Kingdom through a UK branch, agency or permanent establishment, even though he or she is not personally UK resident.

Where some of the trustees are resident and some non-resident, the question is determined by Sections 475 and 476 of the Income Tax Act 2007, by reference to the residence and domicile status of the settlor. If the settlor is resident or domiciled (including deemed domiciled from 6 April 2017) in the

United Kingdom at one or more key times, then the presence of even one UK resident trustee will make the trust as a whole UK resident (the non-resident trustees are deemed to be resident regardless of whether they are in the majority, and regardless of where the trust is actually administered). The key times referred to are the point of creation of the trust and any time thereafter when funds are provided directly or indirectly by the settlor. For this rule, the meaning of 'settlor' is extended to include not only the original creator of the trust, but also "any person who has provided funds directly or indirectly for the purposes of the settlement".

Although an individual is either resident or not resident in the United Kingdom for the whole of a tax year, the statutory residence test, brought in from 6 April 2013, provides for split-year treatment on departure from the United Kingdom or arrival in the United Kingdom under certain conditions. Split-year treatment does not divide the year into resident and non-resident periods, but instead taxes the individual as if he or she were non-resident in the 'overseas' part of the year, subject to a few exceptions. Although split-year treatment cannot apply to a trust, an individual acting as a trustee will not be regarded as UK resident during a split year, when determining the residence status of the trust, if he or she is only a trustee in the overseas part of the year.

An individual trustee coming to the United Kingdom should resign as a trustee before arrival to ensure that the trust does not become accidentally UK resident and subject to significant UK tax liabilities. Assistance may be provided by the United Kingdom's double tax treaty network where a trust is also resident in another jurisdiction under domestic law, with treaty residence likely to be determined on the basis of the place of effective management of the trust. Not all treaties provide a tie-breaker for trusts (eg, see the UK-US treaty), in which case the treaty residence of a trust is left for the competent authorities of the two territories to determine.

(b) Capital gains tax

From 6 April 2007, residence for capital gains tax is the same as for income tax and is enacted as Section 69 of the Taxation of Chargeable Gains Act 1992.

(c) Inheritance tax

The residence of a trust is largely irrelevant for the purposes of inheritance tax. However, it may be important for reporting and liability purposes.

1.7 Protectors

The office of protector is not recognised by trust or tax law, but care must be taken to ensure that the protector is not, by virtue of his or her actions or powers, deemed to be either a trustee or a factor influencing the management of the trust.

If a UK resident protector has powers which effectively make him or her an additional trustee or is effectively making trust decisions, there is a danger that Her Majesty's Revenue & Customs (HMRC) will argue that the trust is UK resident.

2. Income tax

2.1 Trusts in general

A trust cannot be liable to tax because it is not a separate legal person. Liability to income tax on trust income can therefore fall on the trustees, the beneficiaries or the settlor. In fact, in most cases, it is the trustees and/or the beneficiaries who are liable to tax on the trust income. The settlor is not normally liable (except as a beneficiary), but there are certain anti-avoidance provisions that deem trust income to be income of the settlor for tax purposes.

2.2 The offshore interest-in-possession trust

In an interest-in-possession trust, it is the beneficiary who is primarily liable to income tax on the trust income, not the trustees. To that extent, the residence status of the trustees is irrelevant. Although the trust is treated as a mere conduit, the trustees remain liable to account for tax at the appropriate rate on UK-source income of the trust and are responsible for filing a self-assessment trust tax return with HMRC. In computing the amount of income assessable to tax, they may deduct the expenses properly deductible for that source of income. For the treatment of trust expenses, see section 2.2(d).

Some of the income received from the United Kingdom will have had tax withheld at source; where this is not the case, the trustees must pay tax at the appropriate rate. The appropriate rate (for 2019–2020) is as follows:

Dividend income	7.5% (the dividend ordinary rate)
All other income	20% (the basic rate)

The UK resident and domiciled beneficiary will be liable to UK income tax on the trust's worldwide income as it arises, whether or not it is actually paid to him or her. The income does not lose its character by passing through the trust – that is, rental income from land will be assessable as such, on the beneficiary. A beneficiary who is resident but not domiciled in the United Kingdom may elect annually to be liable only on UK-source income and foreign income remitted to the United Kingdom.

(a) Treatment of interest, dividends and rental income

UK-source interest received by the trustees will have been subject to tax of 20% withheld at source. In some cases, the trustees, as non-resident persons, may apply to have the interest paid gross.

The UK resident beneficiary is liable to tax on the gross amount of the interest (ie, on the net interest received, plus the tax withheld), but may claim the tax withheld as a credit against his or her liability to tax on the interest. Foreign-source interest will be taxable as foreign savings income and the beneficiary may claim any foreign tax withheld as a credit, limited to the UK tax liability on the interest.

Non-resident trustees in receipt of UK dividends are treated as having paid tax at the dividend ordinary rate, so satisfying their liability to UK tax. A UK resident beneficiary is liable to tax on the amount of the dividend, without the benefit of any tax credit attributed to the trustees.

Foreign dividends are generally taxable at the same rates as UK dividends. Credit may be claimed for any foreign withholding tax up to the limit of the UK tax liability on the dividend.

Rental income from a UK property will have borne tax at a rate of 20%, which will have been deducted from the rents by the tenants or the managing agents of the property before receipt by the trustees. It is possible for non-resident landlords, including trustees, to apply to have the rents paid gross (without deduction of tax), provided that:

- they have had no previous liability to UK tax;
- they do not expect to be liable to UK tax; or
- their UK tax affairs are up to date.

The trustees must also undertake to comply with all their UK tax obligations in the future. Although it is the beneficiary who is ultimately taxable on the income, it is the trustees who are regarded as carrying on the 'property business' (ie, the letting business) and are liable to account to HMRC for the liability arising from that activity. In this respect, there is no difference between the trustees of an interest-in-possession trust and those of a discretionary trust.

Tax paid or suffered by the trustees may be claimed as a credit by the beneficiary. Again, the rental income received or arising to the beneficiary must be grossed up to include this tax when computing the beneficiary's liability to income tax.

(b) UK resident but non-domiciled beneficiaries

Beneficiaries who are resident but not domiciled in the United Kingdom and taxed on the remittance basis are liable to UK tax on the UK-source income to which they are entitled, as described in the previous section. Their foreign income is taxable only when remitted to the United Kingdom.

(c) Non-resident beneficiaries

A non-resident beneficiary of an offshore interest-in-possession trust will potentially be liable to UK income tax in respect of UK-source income only.

(d) Trust expenses

Provided that the trust deed allows them to do so, the trustees may deduct expenses of managing the trust from the trust income before it passes to the beneficiary. Because different types of income may be involved, the order of set-off may directly affect the beneficiary's liability to tax and is therefore prescribed by Section 503 of the Income Tax Act 2007.

Only expenses that are properly chargeable against income as opposed to capital (overriding in this respect any contrary provision in the trust deed) may be deductible. The expenses are first offset against UK dividends and similar income, followed by the equivalent foreign income, then savings income and finally against other income.

For non-resident beneficiaries, management expenses are allocated between UK-source and foreign-source income in the proportion one bears to the other. Trust management expenses may not be deducted by the trustees against the income on which they are assessable to tax, but only against the income payable to the beneficiary.

2.3 The offshore discretionary trust

(a) The liability of trustees

In a discretionary trust, no beneficiary has an absolute entitlement to income, so the primary liability for income tax falls on the trustees. If the trustees are non-resident, their only liability to UK tax will be in respect of UK-source income. If they have UK resident beneficiaries, the whole of their UK income will be charged; otherwise, only UK property and trading income will be subject to UK tax. The first £1,000 (for 2019?2020) of income is charged at the basic rate or dividend ordinary rate, depending on the nature of the income. The remaining income is charged at the dividend trust rate or the trust rate. For 2019?2020, the former is 38.1% and the latter 45%. Income is chargeable at either of these rates to the extent to which it is to be accumulated or is payable at the discretion of the trustees.

'Distribution income', chargeable at the dividend trust rate, consists of dividends and other distributions from UK corporations and is treated as the highest part of the trustees' total income. Distribution income in the hands of non-resident discretionary trustees is treated as carrying a notional 7.5% tax credit, which is not repayable. They are therefore liable to pay 30.6% tax on this income (the 38.1% dividend trust rate, less the 7.5% credit).

All other income of the trust is chargeable at 45%.

Trustees of an offshore discretionary trust may apply for UK-source deposit interest to be paid gross, if they declare to the deposit taker that they have no reasonable grounds to believe that any of the beneficiaries is an individual resident in the United Kingdom or a UK resident company.

(b) Trust management expenses

In contrast to the rule with an interest-in-possession trust, trust management expenses are deductible from the income on which the trustees are liable to tax at the trust rate (45%) or the dividend trust rate (38.1%). Income against which the expenses are applied is then taxed not at either of these two rates, but at the rate at which it would be taxed if not received by discretionary trustees. When deducting those expenses, they must be grossed up at the relevant rate of tax (ie, at the basic rate of 20% or the dividend ordinary rate of 7.5%). That rate is the rate applying to the income against which they are offset. The order of set-off is as given in section 2.2(d) above.

(c) Payments to UK resident beneficiaries

A UK resident beneficiary receiving a payment of income from non-resident trustees is in law treated as receiving income from a foreign source, however great the proportion of UK-source income in the income out of which the payment is made. The income assessable is the amount actually paid and no credit is available, either for UK income tax or for any foreign tax suffered on the income. The reason for this is that the UK and foreign tax (where applicable) has been paid and is the liability of the trustees, not of the beneficiary. Nor can the beneficiary invoke Section 111 of the Taxation (International and Other Provisions) Act 2010, which allows beneficiaries to 'look through' income received under deduction of foreign tax from a discretionary trust and claim the corresponding foreign tax credit, as this is also effectively limited to beneficiaries of UK resident discretionary trusts.

A measure of relief is available against the harshness of the law under Extra-Statutory Concession (ESC) B18. This concession allows UK resident beneficiaries receiving income payments from an offshore discretionary trust to claim a credit for UK tax actually paid by the trustees on the income out of which the payment is made if the beneficiary would have been liable to UK tax on the income had he or she received it directly. Credit may be claimed only for tax actually paid; any amounts that the trustees could not have offset under Section 496 of the Income Tax Act 2007 from tax due on their payment had they been UK resident are not available to the beneficiary. Chief among these is the notional 7.5% tax credit on UK dividends (see section 2.3(a)). A non-repayable foreign tax credit may also be claimed for non-UK tax suffered by the trustees on foreign income, limited to the relevant UK double tax treaty rate.

This concessionary treatment is made available only where the trustees:

- have made full UK tax returns, giving details of income and payments to beneficiaries in every relevant year;
- have made full settlement of all UK tax liabilities (including penalties, interest and surcharges); and
- have kept tax certificates for inspection.

Beneficiaries must claim credits under this concession no later than five years and 10 months after the end of the year in which the payment from the trustees is received.

(d) Limitation of UK tax on non-residents

Non-residents in receipt of UK-source investment income enjoy a cap on their total liability. In effect, their liability on interest and dividends is limited to tax deducted at source. This cap does not apply to non-resident trustees of a discretionary trust where there is a beneficiary (companies as well as individuals) resident in the United Kingdom, to whom the trustees may pay all or part of the trust income.

(e) Payments to UK resident but non-domiciled beneficiaries

Where the beneficiary is resident in the United Kingdom, but is a non-domiciliary to whom the remittance basis applies, the beneficiary's liability extends only to so much of the payment as is matched to UK-source income or to overseas income that is subsequently remitted.

(f) Payments to non-resident beneficiaries

Payments of income by offshore discretionary trustees to beneficiaries who are not resident in the United Kingdom are entirely free of UK income tax in the beneficiary's hands. The trust will still, of course, have suffered UK tax on any UK-source income received, as described in section 2.3(a). A non-resident beneficiary receiving a payment out of income of the trustees which, had it been received directly, would have been chargeable to UK tax may claim a credit for the UK tax paid by the trustees under ESC B18, as described in section 2.3(c)

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