

# Tainting Revisited: Preserving protected trust status post-6 April 2017

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Over 25 years ago the capital gains tax settlor charge was introduced for offshore trusts. Although the new charge was targeted at trusts established on or after 19 March 1991, those set up prior to that date could also fall foul of the new rules if they were 'tainted' by property being added to the trust. Over the course of time these tainting rules have become less relevant. However, following the enactment of Finance (No.2) Bill 2017 on 16 November 2017, tainting is set to become a hot topic once again due to the introduction of 'protected trust status' which will apply to certain offshore trusts.

## How did we get (back) here?

Just over two years ago the government announced that it was going to introduce new deemed domiciled rules for tax purposes but there would be 'certain protections' for offshore trusts established before a settlor became deemed domiciled under the new regime. However, during the subsequent consultation period it became apparent that if certain additions were made to such trusts they would be tainted and so lose their protected status. Further details of the new protected trusts regime are set out below.

## How does a trust qualify for protected status?

An offshore trust will have protected status if:

- At the time the trust was established the settlor was not UK domiciled under general law and, if the trust was established after 5 April 2017, the settlor was also not deemed UK domiciled at that time;
- The settlor was not a 'formerly domiciled resident' (ie born in the UK with a UK domicile of origin and UK resident for the relevant tax year); and
- The settlor continues to be non-UK domiciled under general law in the relevant tax year.

## What are the benefits of protected trusts?

From 6 April 2017, non-doms who have been UK resident for at least 15 out of the last 20 tax years ('the 15/20 rule') will be deemed UK domiciled for income tax and capital gains tax purposes. Without the introduction of protected trust status, this would have meant that if a UK resident settlor of a trust fell within the 15/20 rule on or after 6 April 2017, the trust income and gains would then be attributed to him for tax purposes on an arising basis (as is the case for a UK domiciled settlor) with the loss of any tax deferral benefits that the trust previously enjoyed.



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However, broadly, for so long as the trust qualifies for protected status, the settlor will not be taxed on foreign income or gains that are retained in the trust (or its underlying entities). Instead he will only be taxed on such income and gains as and when benefits are received from the trust, therefore preserving the trust's valuable tax deferral advantages.

### **When will protected trusts be tainted?**

Protected trusts will lose their protection if funds are added directly or indirectly by the settlor after 5 April 2017 (or the settlement date if later) at a time when the settlor is either UK deemed domiciled or domiciled under general law. Note that additions of value (as well as of property) will be relevant. Tainting will also occur where funds are added by the trustees of any other settlement of which the deemed domiciled (or domiciled) settlor is a settlor or beneficiary.

### **What is excluded from the term 'addition'?**

The Finance (No.2) Act 2017 confirms that the following will not qualify as an addition for the purposes of the tainting rules:

- Property or income provided on arm's length terms, or without an intention to confer a benefit.
- Property or income provided in pursuance of a liability incurred by a person before 6 April 2017. HMRC has confirmed that for this exception to apply a pre-6 April 2017 legally binding commitment must have been made.
- Property or income provided to meet excess tax or administration expenses of a trust over its income for a year.

In addition, HMRC has indicated that the following instances will not taint a protected trust:

- Failure to exercise a power to revoke the trust.
- Where life interest trustees retain income due to the life tenant, but still intend to distribute the income to the life tenant (unless the life tenant leaves his income entitlement in the trust and after a period of time it becomes mixed up with other trust income).
- Non-payment of a dividend by an underlying company, even if this occurs over a number of years.

### **What about loans?**

The Finance (No.2) Act 2017 includes special tainting provisions for loans as follows:

- A loan to trustees on arm's length terms will not taint a trust, provided that there is no capitalisation of (or failure to pay) interest and the loan is not varied so that it is no longer on commercial terms.
- Payment of interest to the trustees in respect of a loan made by them on arm's length terms will not be caught; similarly the repayment of loan principal will not result in tainting.

- Pre-existing loans made by the settlor to the trustees other than on arm's length terms will be regarded as an addition on the date the settlor becomes UK deemed domiciled under the new rules. However, if the settlor becomes deemed domiciled on 6 April 2017 he will have a grace period of until 5 April 2018 either to repay the loan (plus all interest) or to change it to arm's length terms. In the latter case interest must be paid on an arm's length basis for the period 6 April 2017 – 5 April 2018. Pre-existing loans between trusts where the settlor is a beneficiary or settlor of both of them will be treated in the same way.
- Note that for a loan to the trustees to be made on arm's length terms it will be necessary for the loan interest to be both charged and paid at no less than the official rate of interest (2.5% from 6 April 2017) every year. Conversely, the interest on a loan made by the trustees should be payable at no more than the official rate to avoid tainting. Consequently, for inter-trust loans with the same settlor (or where the settlor of one trust is a beneficiary of the other) it will be necessary for the interest rate to match the official rate to ensure that neither trust is tainted.

HMRC has also confirmed that fixed term loans made to offshore trusts (or an underlying company) which predate the tax year in which the settlor becomes UK deemed domiciled will not taint the trust, irrespective of whether they are on arm's length terms. However, uncommercial fixed term loans that are repayable after the settlor becomes deemed domiciled may give rise to tainting if they are not repaid at the end of the fixed term. Note that such loans will also qualify for the grace period which allows repayment until 5 April 2018 if the settlor is deemed domiciled in 2017/18.

#### **What action should be taken now?**

Protected trust status will be extremely valuable to many trusts and therefore it will be important to ensure that it is maintained wherever possible. In particular the following planning points should be considered:

- If a settlor is not yet UK deemed domiciled, consider the funding needs of the trust in advance. If it is anticipated that additions will need to be made by the settlor (or by a trust of which he is also a settlor or beneficiary) ensure that they are made before the year in which the settlor becomes deemed domiciled;
- Once a settlor becomes UK deemed domiciled, take care to avoid inadvertent additions that would taint the trust. In particular, interest on trust loans should be paid promptly; and
- Review existing trust loans and if necessary consider repayment or restructuring as a commercial loan within the relevant time limit.

Finally, it may be worth revisiting the tainting guidance issued for pre-19 March 1991 trusts, in view of the fact that HMRC has confirmed that this will be relevant when ascertaining whether an addition has been made to a trust. Going forward, it will be more important than ever to exercise considerable care when administering a trust with protected status to avoid inadvertent additions being made to the trust. The tainting rules are complex and there are a number of pitfalls to avoid if protected status is to be preserved.

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