TECHNICAL SALES BRIEFING

PROTECTED SETTLEMENTS & INVESTMENT BONDS: A CRITICAL TAX PLANNING STRATEGY

Please note that, within the UK Budget of 6 March 2024, there were some proposals to change the current domicile-based IHT system to a residence-based IHT system with a total removal of the remittance basis from April 2025. These potential changes and the Budget commentary should be taken into account before undertaking any planning in this area.

KEY POINTS

- HM Revenue & Customs (HMRC) have confirmed that any deemed 'income' received from non-reporting funds does not meet the definition of Relevant Foreign Income for the purposes of the protected settlements legislation
- Non-UK resident trusts that hold non-reporting funds will therefore not be protected once income or gains are incurred, such as when the funds are sold
- Life policies could be very useful here as an alternative investment, as they are non-income producing assets
- This briefing explores the protected settlements legislation and details the relevant points.

BACKGROUND

The Finance (No 2) Act 2017 introduced the concept of deemed domicile for the purposes of the remittance basis of taxation. Previously the concept of deemed domicile applied only for Inheritance Tax purposes, but this has now been extended such that the remittance basis of taxation is no longer available for Income Tax or Capital Gains Tax (CGT) purposes to those falling into one of the two following categories:

- **Formerly domiciled residents (FDR):** UK resident foreign domiciliaries who were born in the UK with a UK domicile of origin; and
- **Long term residents (LTR):** a UK resident foreign domiciliary who has been UK resident in at least 15 of the 20 previous tax years.

The extension of the deemed domicile provisions to Income Tax and CGT may have also resulted in an arising tax liability for long term residents in respect of the income and capital gains of non-resident trusts that they settled while non-domiciled and not deemed domiciled. Limited protection from such tax is afforded by the protected settlements legislation.

Further, it should be remembered that people who acquire a UK domicile of choice will not be able to claim the remittance basis of taxation in any tax year. The deemed domicile concept is effectively a tax mechanism to make sure that a person cannot remain with an overseas domicile indefinitely.

The use of the term 'choice' in this context is confusing, as acquiring a domicile of choice is more about a person's intention rather than a specific choice.

More detailed information on domicile can be found in the **Guide to Domicile**, **Remittance Basis and Excluded Property Trusts** which is available in our uTech library.

This information is based on Utmost Wealth Solutions' understanding of current law and HM Revenue & Customs' practice as at February 2019. Tax rules may change and are dependent on individual circumstances. This information does not constitute legal or tax advice and must not be taken as such. The companies in the Utmost Group can take no responsibility for any loss which may occur as a result of relying on this information.

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PROTECTED SETTLEMENTS

It was recognised by HMRC that many non-domiciled individuals living in the UK hold their wealth in non-resident trusts, from which they or their close family members can still benefit. For **long term residents** who have held on to their overseas domicile, losing the remittance basis of taxation would result in them being liable to income tax and capital gains tax on all of the income and gains arising in their non-resident trusts.

The relevant **protected settlements** legislation was therefore introduced in the Finance (No. 2) Act 2017. This provided some protection for non-domiciled individuals who set up non-resident trusts that hold relevant foreign income sources before becoming domiciled or, if the settlement was created after 6 April 2017, before becoming deemed domiciled in the UK (under the 15 out of 20 year rule). Such individuals will not be taxed on the gains and foreign source income of such trusts provided the income and gains are retained within the trust. The protected settlement legislation is now included under s721A Income Tax Act 2007 ("ITA 2007').

It is important to note that these protections do not apply to formerly domiciled resident settlors as confirmed in s721A (1) ITA 2007.

Upon becoming a formerly domiciled resident, as defined in s835BA ITA 2007, they will be treated as UK domiciled and the income and gains arising in non-resident trusts that they may have settled and retained an interest in will be assessable on them as they arise. The settlements legislation, the transfer of assets abroad legislation and TCGA 1992, s86 will continue to apply.

From 6 April 2017 long-term resident settlors are liable to pay income tax on the UK source income arising within a non-UK resident trust structure in which they had retained an interest (as previously). They would also be taxed on any benefits that they received from the trust on a worldwide basis, to the extent that such benefits could be matched with the income and gains arising within the trust. The UK resident non-UK domiciled settlor may also be liable to income and or capital gains tax on distributions made to "close family members".

REMITTANCE VS ARISING BASIS TAX PAYERS

It is important to note that the trust protections not only protect those non-domiciled settlors who have become deemed domiciled under the "15 out of 20" rule, they also protect UK resident non-domiciled settlors who, although eligible, do not wish to pay for the privilege of electing for the remittance basis of taxation. This is a potentially significant benefit for such clients.

PROTECTED FOREIGN SOURCE INCOME

This is a very complex area and one which requires specialist advice. A full and detailed explanation of the protected settlements provisions is beyond the scope of this briefing and the following should be considered a high level summary only. The settlement protections will apply in respect of trust income and gains arising to settlements that have not become **tainted** (see below).

With regard specifically to trust income, the protections are available in respect of **protected foreign source income** so long as the trust has not become **tainted**.

A detailed explanation of the conditions required to be met for trust income to be deemed **protected foreign source income** is provided in ITTOIA 2005, s628A but, in summary, the settlement protections apply where:

- The income would be **relevant foreign income** if it was the income of a UK resident
- The income derives from property originating from the settlor
- When the settlement was created the settlor;
  a) Was not UK domiciled
  b) Is not deemed UK domiciled (if settlement created on or after 6th April 2017)
- At no time in the relevant tax year is the settlor;
  a) UK domiciled
  b) A formerly domiciled resident
- The trust is non-UK resident
- **No property or income is added to the settlement** by the settlor (or from any other trust to which the settlor is a settlor or beneficiary) when the settlor is;
  a) UK domiciled
  b) Deemed UK domiciled.

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TAINTING

The final point above concerning additions to the settlement after the settlor attains a UK domicile or deemed domicile, alludes to the **tainting** provisions. The tainting provisions are found in various parts of the tax code (**TCGA 1992**, Schedule 5 paragraphs 5A & 5B, **ITTOIA 2005** s628A & 628B, **ITA 2007** s721A, 721B & 729A) as they apply in respect of trust gains as well as income.

Where property or income is added to the settlement by the settlor (or any trust to which the settlor is a settlor or beneficiary) when the settlor is either UK domiciled or deemed UK domiciled; the settlement becomes tainted and the settlement protections fall away.

WHAT IS RELEVANT FOREIGN INCOME?

The legislation under s830 Income Tax (Trading and Other Income) Act 2005 ('ITTOIA 2005') provides the full definition and this has been the focus of the recent developments. Here relevant foreign income is, broadly, income which:

a) arises from a source outside the UK; and

b) is chargeable under any of the provisions listed in ITTOIA 2005 s830(2)

OFFSHORE INCOME GAINS (OIGS) AND WHEN IS INCOME NOT INCOME

It is understood that many offshore trusts are invested in non-reporting offshore funds. These funds allow income to roll-up within the fund untaxed until gains are realised on disposal. These are ordinarily subject to tax dependent on residency and whether the remittance or arising tax basis has been elected.

The gains realised on disposal of non-reporting offshore funds are referred to as Offshore Income Gains ('OIGs').

Whether the actual 'gains' on disposal of the fund represent capital appreciation or re-invested income (or both) the gains from non-reported funds are taxed as income and not as capital gains. Importantly these OIGs are therefore 'deemed income' for tax purposes.

Importantly, despite these OIGs giving rise to deemed income, HMRC do not consider that OIGs are relevant foreign income under ITTOIA 2005 s830 despite a technical argument to the contrary being made by several tax bodies. As a result, they cannot qualify as protected foreign source income under s721A ITA '07 if arising to trustees of a non-resident trust.

LOSING CONTROL OVER THE TAX

The tax treatment of OIGs from non-reporting funds presents a dilemma for trustees and/or settlors of non-resident trusts.

The protections explained earlier in this note do not apply to OIGs which means that a UK resident non-domiciled settlor may now be faced with substantial income tax charges when the trustees dispose of the non-reporting funds. This will be of concern for settlors who are:

1) Taxed on the arising basis or, by virtue of being a **long term resident** and therefore deemed domiciled (meet the 15 out of the previous 20 years rule)
2) Are UK resident and currently non-domiciled but unable, or not wishing, to pay for the remittance basis of taxation any longer;
3) Acquire a UK domicile of choice and are caught as UK domiciled and thus not able to claim the remittance basis of taxation.

Not only will a tax liability arise on any gain on disposal of the non-reporting fund but any OIGs are not able to claim any loss. Losses on non-reporting funds are not deductible from OIGs but are relieved as capital losses against ordinary capital gains. They will reduce S2(2) TCGA 1992 gains but not OIGs amounts. Such restrictions limit the opportunity for trustees to reappraise any investment strategy and may have an adverse impact on investment returns.

The gains and tax charges can be avoided of course by simply not disposing of the non-reporting funds within the offshore trust. However, this is unlikely to be a long term solution, as the trustees will want to actively manage their investment portfolio to ensure it continues to meet the trust objectives and risk profile. A long term hold strategy may be especially difficult to achieve where the investment management has been delegated to an investment manager whose mandate is to actively manage the portfolio.

THE PLACE FOR AN INTERNATIONAL BOND?

Single premium international life insurance bonds (as well as capital redemption bonds) may represent a solution for trustees and settlors for the following reasons:

- Life Insurance bonds (as well as capital redemption bonds) are non-incoming producing assets and are not subject to capital gains tax;
- An investment into an international bond will prevent future income and gains accumulating within the non-resident trust;
- Any chargeable event gains may still give rise to income tax charges but when these occur the timing of chargeable events can potentially be controlled by the policyholder (the trustees);
- Where the underlying assets within the policy include non-reporting funds, losses will simply aggregate with the performance of the other underlying assets. This may be preferable to the treatment of losses on non-reporting funds held directly, which may only be offset against capital losses;
- The tax on partial-surrenders (withdrawals) may be deferred using the 5% annual tax-deferred allowance:
  - If the premium came from "clean" capital these 5% withdrawals can be remitted back to the UK without liability to tax;
  - If the premium came from mixed or tainted funds the withdrawals can still be used/spent outside of the UK (not remitted) without giving rise to a chargeable event gain and UK tax liabilities.
- A wide portfolio of investments can still be linked to the value of the policy;
- Rebalancing and active management of the policy does not give rise to a capital gain as CGT does not apply to disposals of assets within the policy. The tax neutral position on buying and selling assets within the policy makes them very attractive for active fund managers who would rather concentrate entirely on their investment mandate than feel constrained by the tax implications of managing the portfolio.
- The policy, or any of its segments, can be assigned to beneficiaries. Any assignment not made for money (or money's worth) does not trigger a chargeable event gain. Assignment is a potentially highly tax efficient way of transferring the tax liability from settlor to beneficiary.

CONCLUSIONS

The protections offered to protected settlements are valuable but are dependent upon meeting the protected foreign source income definitions and the trust not becoming tainted. The tax treatment (and therefore the tax planning opportunities) of an international bond are not dependent on these conditions.

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