Tainted love: ensure your trust stays protected

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Chambers HNW, 2017, Private Wealth Law

The April 2017 tax reforms in relation to foreign domiciliaries brought major changes to the regime that applies to offshore trusts. These changes included the introduction of the concept of a "protected settlement", and the related concept of "tainting". It is crucial for all trustees of offshore settlements with UK resident, deemed domiciled settlors to get to grips with these concepts and the new tax regime. In some cases action will need to be taken before 6 April 2018 to prevent tainting, and the position should be reviewed as a matter of urgency.

Overview

After a lengthy build-up and several false starts, the Finance (No. 2) Act 2017 was finally given Royal Assent on 16 November 2017. It effected many significant changes, with retrospective effect from 6 April 2017, including an overhaul of the tax treatment of non-UK resident trusts with UK resident settlors.

This note focuses on a narrow, but very important topic: how offshore trustees can ensure that trusts settled by individuals who are now deemed UK domiciled under the new 15/20 year rule, or who will become deemed domiciled on that basis in coming years, retain "protected settlement" status.

Generally, a trust whose settlor is UK resident and domiciled will be tax-transparent – i.e. its income and gains will be subject to taxation on the settlor on an arising basis. In contrast, a trust whose settlor is UK resident and non-UK domiciled will be tax-transparent only in relation to UK source income. Where a non-UK domiciled settlor has become deemed domiciled under the 15/20 years rule, the default position is that he or she will continue to be protected from arising basis taxation in relation to non-UK income and gains of the trust. However, this protection is conditional on the trust not being tainted.

Broadly speaking, tainting will occur if value is added to the trust, by the deemed domiciled settlor himself, or by another trust of which he is the settlor or a beneficiary. Once a trust has been tainted by such an addition of value, the loss of protection for the settlor is permanent – he or she will be subject to arising basis taxation on the trust's income and gains, and typically also those of any underlying non-UK resident company, for as long as he or she remains UK resident.

Under the new rules, preventing the loss of protected settlement status is a key consideration for trustees of offshore settlements whose settlors are UK resident and deemed domiciled due to long-term residence in the UK. Tailored advice will be required in each particular case, but we set out below some of the issues which trustees should already be thinking about.

Unfortunately, determining whether a particular transaction or event will cause tainting is not always easy. As is so often the case with tax legislation regarding trusts, the tainting rules appear to have been drafted by someone with a limited understanding of how, in the real world, trust structures operate; and frustratingly, no account was taken of feedback from tax lawyers and accountants after the draft legislation had been published. The rules are intricate and vague by turns. Given the draconian consequences of a trust being tainted, the vagueness of the legislation is particularly concerning.

HMRC released some guidance on 31 January 2018, covering various aspects of the Finance Act which introduced these rules (the "Guidance"), but many questions remain unanswered. This note suggests some answers to questions which the legislation and Guidance do not directly address, but which will arise frequently in practice.

What, exactly, is "tainting"?

Under the new legislation, a trust will be tainted if:

- its settlor is foreign domiciled as a matter of general English law, but
- he or she has become deemed domiciled in the UK due to long-term residence in the UK, and
- property or income is provided directly or indirectly for the purposes of the settlement by the settlor, or by the trustees of another settlement of which he or she is the settlor or a beneficiary.

In this note, we have referred to any such other trust as a "connected settlement", but this expression isn't used in the legislation. Nor, for that matter, are the terms "protected settlement" or "tainting", but they are convenient shorthand and all three terms are used by HMRC in the Guidance.

At first sight, the meaning of property or income being "provided for the purposes of" a settlement is obscure. As discussed below, this formulation derives from older legislation, on which HMRC guidance was issued many years ago; and there is some case law regarding the meaning of property or income being "provided". But although these guides to interpretation exist, this is hardly a shining example of clear legal drafting in plain English.

The legislation does include a list of scenarios in which the reader is directed to "ignore" what might otherwise be considered a tainting event. These can be summarised as follows:

(a) a transaction, other than a loan, which is on arm's length terms;

(b) a transaction, other than a loan, where there is no intention that benefit should be conferred gratuitously;

(c) the making of a loan to the trustees on arm's length terms;

(d) the payment of interest to the trustees under a loan made by them on arm's length terms;

(e) a repayment of a loan made by the trustees;

(f) any action taken in pursuance of a liability incurred before 6 April 2017;

(g) any payment made to the trustees to allow tax liabilities or administration expenses to be met, where the income of the trust is insufficient to cover such costs.

HMRC have provided some clarifications regarding tainting, initially through published correspondence with a number of professional tax bodies and more recently in the Guidance. Unfortunately, the latter is not the comprehensive and detailed guidance that advisers had been hoping for, and in places only increases the difficulty in interpreting the rules. HMRC have indicated that further technical guidance will be released in due course, and we must hope this will prove more useful.

One of the most acute problems with the legislation is its failure to address transactions, and in particular loans, involving companies in which the trust is a direct or indirect participator (for brevity, "underlying companies"). It had been anticipated that the Guidance might provide some commentary regarding the treatment of such transactions but, aside from a short and somewhat cryptic reference, it completely ignores the issue. The particular problems posed by underlying companies are discussed below.

Reasons to be fearful

The tainting rules are draconian. There is no *de minimis* rule, or statutory ability to reverse an inadvertent addition of value. Unless one of the let-outs referred to above applies, any addition, however small, will in principle result in a <u>permanent</u> loss of all trust protections. Great care must be therefore taken, and trustees would be well advised to err on the side of caution, particularly while the legislation is new and there is limited official guidance.

The tainting provisions technically only become relevant from the start of the tax year in which the settlor acquires deemed domiciled status under the new 15/20 year rule. However, it will be prudent for trustees to start considering the application of the provisions in advance of this date. Unless thought is given to

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this point before the settlor becomes deemed domiciled, the trust may become tainted, irreversibly, on the first day of the relevant tax year.

Bounty hunting

Before considering the let-outs in the legislation and HMRC commentary, it makes sense to focus on the meaning of "provide". The courts have held that there is only a provision of income to a trust if there is an element of bounty on the part of the provider – i.e. a subjective intention to cause some benefit or advantage to accrue to the trust or its beneficiaries (*IRC v Leiner,* 1964).

However, an intention to cause such a benefit to accrue may be inferred from the circumstances, even where income has been received by the trust under a transaction which, on the face of it, was commercial. In the Leiner case, the taxpayer was found to have "provided" income to a trust by paying interest to its trustees, notwithstanding that such interest was paid at a rate which was accepted as being market. He did not need the loan, and his subjective intention in borrowing from the trust on market terms was, it was found, to cause income to accrue to the trust, which could be used to benefit his son.

The Leiner case was concerned with a different part of the tax code, but there is no reason to think that "provide" should be interpreted differently in the context of the new tainting provisions. The question to ask, it is suggested, is whether something has been done which has caused something to be received by the trustees, or by an underlying company; and if so, whether there was a subjective intention that the trust or any of its beneficiaries should benefit from that receipt.

If this is indeed the legal test, then some of the let-outs cited above seem to be purely confirmatory, and effectively redundant. If "provision" requires an element of bounty, then self-evidently there cannot be any provision of property or income under a transaction if there is no intention that benefit should be conferred gratuitously (let-out (b)). In addition it is hard to see how the repayment of a loan (see let-out (e)) would ever be bounteous.

Clearly, a gift of funds from a deemed domiciled settlor directly to the trustees will be a tainting event, unless it falls within the exemption allowing expenses of "dry" trusts to be met (let-out (g)). Similarly, an addition of value to a trust asset, such as building an extension to a property owned by the trust, or a gift to a company owned by the trust, will normally taint the trust if the settlor is deemed domiciled.

By contrast, a commercial transaction with no bounteous intent should not taint the trust. But care needs to be taken with apparently commercial arrangements where the motive is in fact bounteous (as in the Leiner case).

Moreover, the question of whether something has been received by the trust or an underlying company must be answered in the round, taking into account any act by the settlor or the trustees of a connected settlement which may have indirectly enhanced the value of the trust fund. For example, it appears that property or income will be provided for the purposes of a settlement if its settlor guarantees a bank loan taken out by the trustee (as in *IRC v Wachtel*, 1970).

Neither a borrower nor a lender be …

Perhaps the most intense area of concern in relation to tainting is loans. Loans are of course commonly used as a means of funding trusts or providing liquidity to the settlor or other beneficiaries.

The potential for a loan, or a payment made pursuant to a loan arrangement, to cause tainting is significant. In principle, there is scope for protected settlement status to be lost if:

(a) a loan is made to the trust;

(b) a debt due from the trust is left outstanding when repayment could be demanded;

(c) interest is paid to the trust under a loan made by the trustees; or

(d) the principal of a loan made by the trustees is repaid.

As discussed below, the number of potential tainting events is doubled when loans by/to underlying companies are also included in the mix. However, if it is correct to say that in this context the word “provide” must be interpreted in line with the Leiner case, then there will need to be an element of bounty for any payments made in relation to a loan to be tainting events.

Moreover, the legislation specifically provides that a loan to the trustees on arm’s length terms can be ignored (let-out (c)). Such a loan will not result in protected settlement status being lost, even if the settlor’s subjective intention in making the loan is to confer some benefit. This might be the case, for example, where the loan is being made to enable the trustees to take advantage of an investment opportunity which has significant growth potential.

Similarly, there are express let-outs for interest payments to the trust made on arm’s length terms, and for principal repayments (let-outs (d) and (e)).

An obvious but important point to make is that loans within a single trust structure (eg between the trust and its underlying company, or between two underlying companies of the same trust) cannot constitute tainting, regardless of their terms.

Arm's length terms

One of the curiosities about the tainting legislation is the fact that, in relation to loans, it defines "arm's length terms", instead of leaving the natural meaning of this expression to apply.

No doubt the reason for this is that, in practice, it can be very difficult to establish what terms would apply to a loan if the parties were unrelated. However, the result of giving the expression a statutory meaning is that a loan may be on commercial terms, in the ordinary sense, without it being on arm's length terms within the meaning of the statute - or vice versa! This is confusing to say the least, and contributes to something of a minefield around loans to and from trusts.

For the purposes of the tainting provisions, where a loan is made by the trustees, the interest payable cannot exceed HMRC's official rate (currently 2.5%) for it to be on arm's length terms. For loans made to the trustees, interest must be paid at a rate no less that the official rate.

Interest rates which are too low or high can result in a potentially taxable benefit or other tax charges, so there is a balance to be struck:

Parties	Interest requirements / implications
Settlor lending to trustees	Interest must not be lower than the official rate if tainting is to be avoided. If interest is paid at higher than the official rate, the excess will represent a potentially taxable benefit.
Trustees lending to settlor	Interest must not be higher than the official rate if tainting is to be avoided. If any interest is paid by the settlor and the trust is settlor-interested, the settlor will be taxed on the income paid by him/herself. Otherwise income may be taxable for the trustees. If no interest is paid, or interest is paid at less than the official rate, the shortfall will represent a potentially taxable benefit.
Trustees lending to trustees	Interest must be at exactly the official rate.

In many cases, loans should be subject to interest at the official rate, to avoid the Scylla of tainting and the Charybdis of taxable benefits. However, where the deemed domiciled settlor is the borrower, it may be preferable for the loan to be interest-free and for him/her to pay tax on the interest forgone, so that no UK source income arises to the trustees. If interest is paid, the tax on the interest may exceed the tax that would be payable on interest forgone. Perhaps more importantly, the receipt of taxable income by a settlor-interested trust can generate tax compliance complexities which are best avoided.

One of the many issues which is unclear from the legislation is whether, for a loan made to trustees to qualify as being "on arm's length terms", the interest rate needs to track the official rate, or whether a fixed interest rate is acceptable provided that it matches the official rate at the time of the making of the loan. HMRC's view in the Guidance is that, if a loan is initially made subject to interest at a rate equal to the official rate in force at that time, a subsequent reduction in the official rate will not give rise to tainting, even though after the change the trustees will be receiving interest at a rate greater than the official rate then in force. On this point, the Guidance does not expressly differentiate between term loans and on-demand loans. It appears, therefore, that in HMRC's view, tainting will be avoided in this scenario even if the loan is repayable on demand.

However, where tainting of a settlement must be avoided, there are distinct dangers in a fixed rate loan being made to its trustees. One issue with such a loan is that in HMRC's view a fairly minor change to the terms of the loan, such as a change to the frequency with which interest must be paid, may be treated as a refinancing, i.e. a deemed repayment and new loan. It is questionable whether HMRC are right, but the corollary of their view is that if there is an amendment to the loan terms, the interest rate must be adjusted to match the official rate in force at such time, if tainting is to be avoided.

Moreover, in many cases further advances will be made from time to time, and each such advance will effectively be a new loan. Any such advance must be made subject to interest at the then-prevailing official rate, to avoid tainting.

The safer course is therefore for any loan agreement, to which the trust or an underlying company is a party, to provide for interest to be paid at the official rate from time to time. In other words, generally there should be a floating rate.

Payday blues

Even where a loan is made to trustees on "arm's length terms" there are several traps which can cause tainting. The first point to note is that it is essential for the borrower to actually pay the interest payable under the loan – the capitalisation or "rolling-up" of interest may cause tainting.

Tainting may also occur where there is a "failure to pay interest in accordance with the terms of the loan". It might be thought that such a failure would need to constitute a serious breach of the loan agreement, ie a failure to pay interest altogether. However, HMRC indicate in the Guidance that in some circumstances they will regard the mere late payment of interest as a failure to pay interest in accordance with the terms of the loan. In examples given in the Guidance, a delay of ten days due to an administrative oversight will not taint the trust but, in contrast, regular/persistent delays of between a week and several months will taint a trust from the first missed interest payment date. The views expressed by HMRC on this point have no statutory force and clearly, even if one accepts them, there is a large grey area here.

While most trustees will doubtless put procedures in place to ensure interest payments are made on time, there are likely to be many occasions where late payments could occur due to cash flow issues, personnel changes and clerical errors. The consequences of tainting can be so catastrophic that loan agreements should be very carefully worded to provide trustees with maximum flexibility regarding payment arrangements, to limit the risks of delay.

Praying for grace

Generally, it is fair to say the loans made <u>to</u> a trust with a deemed domiciled settlor are more perilous than loans made <u>by</u> such a trust.

One reason for this is that there is a draconian provision in the draft legislation, which says that if a loan is made to the trust by the settlor before becoming deemed domiciled under the 15/20 years rule, and the loan is not “on arm’s length terms” (as defined), and the loan is repayable on demand on or after the deemed domicile date, the amount due under the loan will automatically be treated as property provided for the purposes of the settlement on the date on which the settlor becomes deemed domiciled. Taken literally, this is exceptionally harsh. It suggests that if a fixed term loan has been made on interest-free terms, or at an interest rate which is less than the official rate, then even a day’s delay in securing repayment of the loan at the end of the fixed term may result in the trust being tainted.

This rule is subject to an express one year’s grace period where the deemed domicile date is 6 April 2017. In this case, provided (i) the loan and any interest on it is repaid before 6 April 2018 or (ii) the loan is put onto arm’s length terms before that date, no tainting will be deemed to have occurred.

There is no parallel grace period for loans made <u>by</u> trustees. In some cases a loan to the settlor may have been made prior to 6 April 2017, under which interest is required to be paid at a rate that is higher than the official rate. However, if so, let-out (f) should save the day. Arguably, interest can continue to be paid at the agreed rate, without that causing tainting, on the basis that the interest payments are pursuant to a pre-6 April 2017 liability.

Underlying companies

Let-outs (c), (d) and (e) are expressly limited to loans made to the trustees of the trust. Similarly, the grace period discussed above does not extend to loans made to or by companies. It is conceivable, therefore, that any loan whatsoever made to an underlying company, by the deemed domiciled settlor or a connected settlement, will cause a loss of protection.

The Guidance makes a single reference to underlying companies:

> "…*although reference is made in the following example to additions being made to trusts, it is considered that the same consequences will arise where additions are made to companies owned by the non-resident trustees. The tainting rules are not avoided by making additions to such underlying companies rather than to the trusts that own them.*"

This point is obvious from the legislation, which states that an addition of value to any property comprised in a settlement is to be treated as the direct provision of property for the purposes of the settlement. HMRC's statement does not, therefore, add a great deal. However, it is perhaps an indication that HMRC believe that all references to trusts and trustees in the legislation should be purposively construed to extend to underlying companies. That approach would be logical, but arguably it goes beyond the proper remit of statutory interpretation. There is a strong case that the legislation needs to be amended to address underlying companies expressly.

The lack of clarity about loans to underlying companies is immensely unhelpful, as such loans are common and there will be many situations where such loans are already in existence. Where possible, new arrangements involving loans to underlying companies from deemed domiciled settlors, connected settlements or companies held by such settlements should be avoided. Instead, loans should be received at trust level, on "arm's length terms" as described above, with funding then passing down the structure as necessary.

However, where loans to underlying companies are already in place, the trustees will need to consider what action to take. While it is reasonably clear that the making of a loan is a provision of property, it is not clear that the omission to charge interest on an existing loan to an underlying company is a provision of property. On one view, leaving a loan to an underlying company interest-free does not result in an addition of a value to the trust property. It is only if the position is compared to a hypothetical alternative scenario, namely commercial bank borrowing, that an addition of value arises; but the legislation seems to be asking whether value has been added in absolute terms, not compared to possible other transactions.

Arguably, then, an interest-free loan to an underlying company which is made before the settlor becomes deemed domiciled can be left outstanding after the settlor's change of tax status, without this resulting in tainting of the settlement. However, it is not clear whether HMRC would agree with this approach.

Many trustees will wish to "play safe" and put any such loan on interest-bearing terms from the date of the settlor's acquisition of deemed domiciled status, with the rate of interest pegged to the official rate from time to time. However, that may have tax consequences for the lender. Advice should be taken on the options and their respective pros and cons.

Fixed term loans

HMRC have confirmed in the Guidance that where a fixed term loan has been made by the settlor to the trustees prior to his or her deemed domicile date, the continuation of that loan will not cause tainting. However, if the loan is not repaid in full at the end of the fixed term, the trust will become tainted unless the loan is immediately converted into a one "on arm's length terms".

Action points

- Trustees should review all existing loans and take appropriate steps to prevent tainting in advance of the settlor becoming deemed UK domiciled.
- Loans made to the trustees by the settlor or a connected settlement should either be repaid in full or made subject to interest at the official rate from time to time, before the settlor becomes deemed domiciled. Where under the new legislation the settlor will have acquired deemed UK domiciled status on 6 April 2017, these steps must be completed prior to 6 April 2018, to avoid a tainting event this tax year.
- Loans made by the trustees to the settlor or a connected settlement should also be repaid in full or made subject to interest at the official rate, before the settlor becomes deemed domiciled. However, it appears that loans made under pre-6 April 2017 agreements can continue on their existing terms, even where the applicable interest rate exceeds the official rate.
- Loans made after the settlor has become deemed domiciled should generally be subject to interest at the official rate. A possible exception is where the loan is to the settlor, where it may be preferable for the loan to be interest-free (discussed above).
- Loans to and from underlying companies should be avoided where possible until further guidance is issued. If such loans are already in

existence, professional advice should be taken on the pros and cons of amending their terms to make them “arm’s length”, vs leaving them on their existing terms.

Expenses

As already noted, the legislation includes a direction to disregard payments to a trust to allow tax liabilities or administration expenses to be met, where the income of the trust is insufficient to cover such costs (let-out (g)). This will undoubtedly be very useful in relation to so-called “dry” trusts, i.e. those which hold only non-income-producing assets such as houses.

This exemption has its limits. It is, of course, common for an offshore trust to hold investments or other assets via an underlying company, and if so, that company will itself have administration costs and potentially also tax liabilities. But let-out (g) is confined, in its terms, to tax liabilities and administration expenses of the trust and HMRC have expressly confirmed in the Guidance that expenses of underling companies are not covered by this let-out.

The new Guidance does not offer any further discussion of let-out (g), but HMRC’s Statement of Practice 5/92, the old guidance on the so-called “golden trusts” may be of some assistance. “Golden trusts” were certain pre-March 1991 trusts which, after that date, qualified for a favourable CGT regime, provided that (inter alia) no property or income was provided for the purposes of the settlement otherwise than under a transaction at arm’s length. There was a very similar exemption to let-out (g) under these “golden trust” tainting rules and SP 5/92 included some helpful examples of expenses which were regarded as falling within or outside this exemption, including:

Qualifying expenses	Non-qualifying expenses
All UK and foreign tax, including interest and penalties	Loan interest
Certain costs incurred under the terms of the trust in obtaining information relating to beneficiaries’ tax liabilities. This seems to encompass the costs of obtaining legal/tax advice	Costs of acquisition, enhancement and disposal of trust assets

It remains to be seen, of course, to what extent HMRC will stand by the guidance which was issued in 1992, in a very different fiscal climate.

Action points

- For “dry” trusts, or those with a low income yield, settlors should consider adding cash to the trust prior to becoming deemed UK domiciled, to fund future expenses. This particularly applies to trusts with underlying companies, where let-out (g) will not provide a full solution to liquidity issues.

- Where the settlor has already become deemed UK domiciled, trustees should take advice before accepting any kind of contribution from the settlor and should ensure that the settlor does not inadvertently taint the trust, for example, by paying a maintenance bill for a trust property.

Asset sales and use of trust assets

Mistaken valuations

Under the old tainting rules, which applied to “golden trusts”, asset sales between trusts and their settlors were a high-risk activity. There is plenty of scope for such a transaction to result in value passing into the trust, due to an asset being sold to the trust for less than its market value or, conversely, being sold by the trust at an overvalue.

A mismatch between the value of an asset sold and the consideration paid for it may arise due to lack of care being taken with valuation, or even despite the best efforts of the parties to ensure that the amount paid is market. There have been cases in which, due to mistakes as to fact or law, assets have been sold for the wrong price despite the desire of both parties to ensure that they are sold for their market value (see e.g. *IRC v Spencer-Nairn*, 1991).

Fortunately, the difficulties which can arise with such sales are recognised, and the current tainting rules are lenient in this regard. Let-out (b) directs the reader to ignore any property or income provided without any intention to confer a gratuitous benefit.

This should provide reassurance in those cases, of which there will surely be many, where value is added to the trust inadvertently. By way of illustration, if the settlor were to transfer a piece of land to the trustees, at what the parties believed was full market value, but it later transpired that the land had previously unknown development or mining potential which significantly increased its value, let-out (b) should eliminate any risk of the transaction tainting the trust. An example in the Guidance confirms this point.

As discussed above, there is in fact an argument that let-out (b) is unnecessary to secure this result, as a transaction which is thought to be on arm’s length terms lacks the element of bounty required for there to be a “provision”. But even if the exemption is superfluous, it is comforting.

Pre-existing contractual arrangements

In addition, let-out (f) may be relevant in the context of asset sales, as a saving provision for existing contractual arrangements. Where an obligation has been incurred prior to 6 April 2017 but falls due sometime following that date, any property or income provided in satisfying that obligation can be ignored.

For example, if the settlor were to grant the trustees an option over certain shares based on the market value of the shares at the time, but the shares had increased in value by the time of the exercise of the option, let-out (f) confirms that the trust will not be tainted by the trustee's exercise of the option. Again, the exemption is probably superfluous, as it is hard to see how meeting a pre-existing contractual obligation could in itself be bounteous.

However, it may be that let-out (f) is intended to cover more informal obligations. An example in the Guidance states that where a settlor has agreed before 6 April 2017 to provide cash to the trustees to assist with the purchase of a property, the subsequent provision of the cash after 6 April 2017 will not taint the trust. Presumably some written evidence will be required to evidence the earlier agreement.

Use of trust assets

There is a potential conflict between the tainting rules and the new valuation of benefit rules, also introduced by the Finance (No. 2) Act 2017.

Where a deemed domiciled settlor has the use of a chattel owned by the trust, under a licence from the trustees, and he or she pays a licence fee to the trustees, at first sight the amount paid should be "market" to ensure that there is no tainting of the trust. An "above market" licence fee would, seemingly, cause loss of protected settlement status. However, the settlor may need to pay an "above market" licence fee for the use of the asset to avoid having a taxable benefit under the new valuation of benefit rules. These rules calculate the benefit of possession of tangible property by multiplying the acquisition cost of the property or its market value at acquisition by the official rate of interest, rather than looking at the property's current commercial "rental" value. The commercial "rental" value tends to be very low compared to the current capital value of the asset – often in the region of one per cent.

If the settlor pays more than the commercial "rental" value to avoid a taxable benefit, prima facie, this will result in tainting. The legislation has not attempted to reconcile this mismatch, but HMRC have addressed the issue in the Guidance. They say that "they will not enforce the law" where a settlor pays more than the going rate for the licence, to avoid a taxable benefit. Arguably, this scenario should be protected by let-out (b) in any event, since the settlor clearly has no gratuitous intent. The payment of an "above market" licence fee in this situation would be driven by a quirk of the tax legislation, not a desire to confer value on the settlement or its beneficiaries.

However, HMRC go on to state that if the trustees are "renting" an asset for a commercial fee, in order to make it available to the settlor, who then pays an "above market" fee to "rent" the asset from the trust, they will treat this as a tainting event. This interpretation does not seem entirely correct. It is the settlor who must have a gratuitous intent in providing property or income to the settlement, for tainting to occur. The terms on which the trustees have acquired the asset will normally be irrelevant to the question of the settlor's intention in paying more than the going rate to the trustees. In any event, the scenario seems far-fetched.

Action points

- Generally, trustees should ensure that all transactions with the settlor, a connected settlement or a company held by such a settlement are effected on arm's length terms.
- Wherever possible, contemporaneous evidence as to the market value of the asset at the time of the transaction should be retained, e.g. professional advice, sale prices of comparable assets, or third party offers to buy/sell the asset. An intention to transact on arm's length terms should be recited in the agreement.
- It may be prudent to include a price adjustment clause in the agreement for sale. This may not in fact be necessary, in view of the bounty requirement and let-out (b), but such a clause will be strong evidence of the parties' intention to buy/sell the asset for its market value.

Income rights and settlement powers

In correspondence with professional bodies, HMRC have previsouly made a number of statements regarding rights and powers under trusts, some of which have been clarified / confirmed in the Guidance.

Life interest trusts

One question which has been raised is whether a trust with a deemed domiciled settlor who is also a life tenant will be tainted if the settlor / life tenant allows trust income to be retained within the trust instead of being paid out to him/her. HMRC have indicated in correspondence that in this situation the trust "may" be tainted, although a mere delay in payment of the income to the settlor / life tenant will not necessarily result in a loss of protected settlement status.

Clearly, this is not a very categorical answer. To be fair to HMRC, the legal analysis if a life tenant allows income to be retained by the trust is debatable and probably fact-specific. A possible response to the question is that if the trust gives the settlor a right to income, the income should be distributed to him/her to avoid tainting, although in principle it could then be loaned back to the trust on arm's length terms.

HMRC have confirmed in their Guidance that they do not consider there to be a requirement for the profits of underlying companies of a life interest trust to be paid by up to the trustees by way of dividends. They state that the retention of these profits will not be considered an addition of value for the tainting rules.

Powers of revocation

More usefully, HMRC have confirmed that an omission by a deemed domiciled settlor to exercise a power of revocation over a trust will not taint the trust. This seems to be the correct analysis, on the basis that, arguably, there is no recurring or continuous bounty by the settlor in not exercising his/her power of revocation; the bounteous act was the creation and funding of the trust in the first place. Nevertheless, it would have been comforting if the final legislation had included an express let-out for omissions to exercise settlement powers.

The analysis ought to be the same in the event that a deemed domiciled settlor holds, but does not exercise, a general power of appointment which could be used to appoint the trust fund to him/herself.

Less helpfully, HMRC have confirmed that failure by a settlor to exercise a right of recovery of tax from the trustees will be regarded as a tainting event, unless there has been a genuine attempt to enforce that right which has failed. They clarify that, in the case of the right to reclaim tax from the trustees, no tainting will arise if the settlor claims reimbursement within "a reasonable time".

Get out of jail – somewhat expensively?

There is no statutory provision allowing an intentional addition to a trust to be reversed if it was made in ignorance of the tax implications. As discussed above, let-out (b) deals with scenarios where there is no bounteous intent, not scenarios in which there was no intention to taint.

Despite the best efforts of advisors and trustees, it seems very likely that gifts or transactions will occur, in ignorance of the rules, that will push trusts with deemed domiciled settlors into the dreaded non-protected settlement regime.

However, in such circumstances, the equitable doctrine of mistake may represent a "get out of jail" card. This doctrine is somewhat nuanced, but the key requirements are that:

(a) there must be a distinct mistake, which

(b) led to the transfer/disposition of property and which

(c) is sufficiently serious that it would be unconscionable for the recipient to retain the property.

If the court considers that the doctrine applies, it may order the mistaken disposition to be set aside (ie declared void). If so, the result will be that the tainting did not occur.

Although mere ignorance or inadvertence is not sufficient to demonstrate a distinct mistake, the courts are generally willing to infer a tacit assumption where the evidence so permits. In a case where a settlor has been accustomed to making gifts to a trust and was not aware of the new rules, it seems likely that the court would find a distinct mistake, satisfying the first requirement. The second is clearly met, as no settlor fully aware of the implications of tainting a trust would take action to do so. It should be noted that incorrect professional advice (for example that a particular addition would not taint the trust) does not preclude relief.

The most difficult point is likely to be showing that the mistake was of sufficient gravity to render it unconscionable for the trust to retain the funds. The courts are, at best, not very sympathetic to wealthy taxpayers at present (and at worst, downright hostile); and a court may not consider the loss of a beneficial tax regime sufficiently serious for the doctrine to apply. However, a number of recent cases dealing with tax mistakes have shown judges to be willing to accept that significant negative tax consequences can be sufficient for the doctrine to be applied, even where the taxpayer had been seeking a tax advantage in making the mistaken dispositions.

The legal costs of making a claim based on the doctrine of mistake will not be insubstantial, and there is no guarantee of success. This is obviously a situation where prevention is better than cure. But where the alternative is for the deemed domiciled settlor to be subject to arising basis taxation on the trust's income and gains, in perpetuity, a mistake claim may well be worth a shot.

Phone a friend

The tainting rules are likely to be a major source of negligence claims against trustees in the coming years. The complexity of the rules and the drastic consequences of protected settlement status being lost mean that trustees who are potentially affected by these rules should seek professional advice as a matter of urgency.

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