THE USES OF TRUSTS

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It is not so very long ago that the trust was the centrepiece of much tax planning. One form of trust which may still be regarded as "mainstream" is the settlement of excluded property by the non-domiciled settlor who is about to become deemed domiciled. Otherwise, the trust is, for the most part, useful only in the side-streams of tax planning. But there it can play a number of interesting – and important – roles.

Discretionary Trusts

The discretionary trust itself may have passed its use-by date, but the principle on which its former usefulness was based – that a discretionary interest has no ascertainable value – is still a valid one, and there are still many uses for an asset whose value depends on the exercise of a discretion by one or more persons other than the holder. If, for example, I make a gift of such an asset, this has no inheritance tax consequences, because my estate is not diminished. The gift will give rise to no capital gains tax liability, because the deemed consideration on the disposal is nil. If I acquired the asset for consideration from an unconnected third party, the acquisition immediately reduces my estate for inheritance tax, and for capital gains tax the disposal will produce a loss. Discretionary shares in a company – shares which carry no fixed right to dividend or distribution in winding-up – may be used for this purpose, but units in a unit trust (onshore or offshore) are an attractive alternative, if only because the constitution cannot be changed by voting, and one does not have to worry about minority rights and reduction of capital. The offshore unit trust has the advantage over its corporate counterpart that its residence – or, more exactly, the residence of the trustee – will generally be easy to establish, and the further advantage that it really has no equivalent of the "shadow director".

Voting Trusts

The "management and control" which determines the residence of a company is that of the directors, and the identity and residence of its shareholders is not in itself relevant. Nevertheless, HMRC are apt to contend that where a UK-resident individual is the controlling shareholder in a company which holds investments and carries on no other business, the company is *prima facie* to be regarded as resident in the United Kingdom. Vesting the shares in an offshore voting trust, of the kind illustrated in the judgment in *Booth v. Ellard* [1978] STC 487, may alleviate this problem. A similar effect may be achieved by dividing the company's share capital into voting shares of little value, which are held by an offshore trust for the benefit of others, and non-voting shares which have the principal value and are held by the individual.

Trusts for Transfer Pricing.

I came across this manoeuvre in the context of a non-resident individual with a major stake in a US corporation. In that case, the problem lay with the US transfer-pricing rules, but I guess the structure would be equally applicable to the United Kingdom, and indeed to many other countries. The individual owned some Eastern European manufacturing companies which did business with his US corporation. He wanted to make his profit in the manufacturing companies, and he would like to have charged a very high price to the US corporation, which buys and distributes the product. This would, of course, run into transfer pricing difficulties. He therefore adopted an alternative structure. The manufacturing companies were held by an offshore trust for the benefit of the employees and employed him at a salary which effectively mopped up the manufacturing super-profit.

No-value Trusts

The focus of the attack on trusts has been – naturally – on the value of their assets and the income and gains they produce. But a trust can be a very useful holding vehicle for an asset which has no value – or at any rate has no present value, though it may become valuable in the future. The usefulness here is an example of the proposition that a future tax is always cheaper than a present tax. There may be some tax-free roll-up in the meanwhile, and moreover, by the time the taxable event occurs, the tax rate may be lower or the taxable persons may be non-resident. An interest in a discretionary unit trust, of the kind I discuss above, is an example of a "no-value" asset. Or take the case where three different trusts license patents or processes to a single user, on terms that the aggregate licence fee is to be ascertained annually, but to be paid only at a later date, and then in proportions to be determined, in the absence of agreement, by a third party (with arrangements for deposit of the accumulating aggregate as security). In those circumstances, although the user gets the deduction for the aggregate liability, the trustees have no taxable income until the proportions are determined, and in the meanwhile the trustees have effectively been investing the government's money for their own benefit, and – again – tax rates may then be lower, or the trustees may be resident in a treaty country, or indeed the beneficiaries may have sold their interests to a third party who can deduct the cost of purchasing them, and if the trust has UK-resident trustees, no capital gains tax arises on the sale.

Trusts for Non-Residents

In the United Kingdom, we by now have quite a long tradition of tough taxes for our own people, alongside nicely-designed loopholes for foreigners – tax-free gilts, freedom from tax on outgoing dividends, UK companies resident in treaty countries and, even now, the benefits of excluded property and remittance basis for non-doms. A blatant exercise in attracting "loophole" business is the tax exemption for the foreign income and gains of the UK-resident co-trustee, where the settlor is non-resident. Will the intending settlor think this structure an improvement on a trust in – say – the Cayman Islands? Well, one advantage is something which comes under the general head of "cosmetics": if a foreign – let us say French, but no doubt it could be Peruvian – tax inspector spots a UK-resident company in a transaction, he may well be inclined to turn over the page; but if he spies a Cayman company, he may order an inquiry. And the United Kingdom has the further advantage, that (so far at any rate) a trust company does not require a licence and is not required to have a name which indicates that it is not the beneficial owner of the trust assets. There seems no reason in principle why a person who is a "resident of the United Kingdom" should be denied the benefit of the tax treaties to which the United Kingdom is a party because he is a trustee, unless the relevant treaty so provides, or unless he is a mere nominee or has a beneficiary with an interest in possession. But the effect is anomalous: it can indirectly confer the benefit of the tax treaty on individuals who – one would think – have no business enjoying it. It is understood that the OECD is currently considering the problem, but the best solution in the meanwhile seems to be imitate the legendary

Portsmouth and General Investment Company Ltd, which was a co-trustee and sold a major share in a Spanish manufacturing company, without it ever being suggested that it was liable to capital gains tax in Spain.

Second-hand Trusts

These have a long history, stretching back (to my knowledge) to the mid-1960's. Their advantages are simply explained: if I acquire from an unconnected third party his interest in a (generally offshore) settlement, I am not the *settlor* for the purposes of ITA 2007 s.467 (income tax), TCGA 1992 s.68A (capital gains tax) or IHTA 1984 s.44 (inheritance tax), nor am I the *transferor* for the purposes of ITA 2007 s.720. These are signal advantages, but the technique has been little used, largely – it seems to me – because so few people, over the course of the last half century, have had the *nous* to warehouse suitable interests.

Thin Trusts

These are trusts in which – typically – the settlor is the life tenant and has a general power of appointment over the reversion. They have been used in the past to facilitate the realisation of a gain tax-free by the sale of the life tenant's interest, but this was greatly curtailed by the enactment of Schedule 4A to TCGA 1992, which requires the trust assets to be revalued on that occasion, and their use is now restricted to cases where the asset is not a chargeable asset or has no ascertainable value (like the unit trust units mentioned above).

Barbados Trusts

These are interesting in a UK context, because they offer an opportunity to "treaty-shop" income which has a UK source, notably royalties. The treaty exemption from UK tax on outgoing UK royalty income is conditional upon the incoming royalty being subject to tax in Barbados. A trust with a resident trustee satisfies this condition: it is treated in Barbados as a resident person and its income is fully taxable. Barbados, however, is one of the countries in which trustees deduct, in computing their taxable income, the income they pay to their beneficiaries. If a regular Barbados domestic trust has a Barbados Exempt Trust as a beneficiary, its distributions can reduce its taxable income to a trifling amount, while the Exempt Trust is free of tax on its receipts.[1]

Twin Trusts

Assiduous readers of the *GITC Review* will recall my story of Mr. Lee (*GITC Review* Vol IX No 2 p 29). Mr. Lee lives in Hong Kong, but he has no Hong Kong tax problems. His problem is with the UK tax system, and that is because a number of his grandchildren live in the United Kingdom. He has been in the habit of making gifts to his grandchildren from time to time. He has had no problem about that: he has income from investments abroad, which is not taxed in Hong Kong. He has used that income to make the gifts. The recipients are not liable to any UK tax on the gifts. What he wants to achieve is that support for his grandchildren should continue after his death, and this involves creating a trust for their benefit. The trouble, he discovers, is that while gifts from a non-resident individual are not taxed in the United Kingdom, gifts by non-resident trustees can be subject to income tax or capital gains tax in the hands of the donee. In the story, the problem was solved – at least for the next twenty-five years or so, by dividing the beneficiaries into two groups and making two settlements: in one settlement, the first group of beneficiaries could benefit from the initial capital, but the income and gains were to be accumulated for the ultimate benefit of the second group of beneficiaries, while in the other settlement, the second group could have the initial capital but the income would go to the first group. This would keep the income free of tax, but it would not work for capital gains. The solution to that problem was to make the two settlements trading trusts, so that all the gains which would otherwise be capital gains would be included in the trading profits and have the character of income. Such a structure will of course cease to be useful once all the original capital has been distributed, but if the return on investment is 4%, the trustee can distribute an equivalent amount out of capital for 25 years before the initial capital is exhausted. That's a very respectable time for a piece of tax planning to last – and it could be even longer if the settlor revoked and re-settled, or advances were made to adult beneficiaries in appropriate jurisdictions, who re-settled on similar (but not identical) trusts.

[1] I am indebted to Anthony Murty FCA for his research into this concept.