THE RATE OF CAPITAL GAINS TAX ON IMPUTED GAINS OF OFFSHORE TRUSTS AND COMPANIES

Robert Venables Q.C.[1]

1 Changes in Rate of Capital Gains Tax: General

1.1 Overview

United Kingdom capital gains tax was formerly charged at a flat rate of 18%, after allowing for allowable losses, reliefs and annual exemptions. The only exception was in the case of entrepreneurs relief.[2]

It was announced in the June 22nd Budget Speech that the flat rate would be replaced by a rate of either 18% or 28%. Broadly speaking, in the case of an individual, the rate is 18% as regards the unutilised portion of his basic rate band for income tax purposes and 28% as to the excess.

Finance (No 2) Act 2010 section 2 and Schedule 1 enact the new law. (References to "Schedule 1" are to Schedule 1 of Finance (No 2) Act 2010.) This is done in part by amendment of the Taxation of Chargeable Gains Act 1992.

The new law applies in general to gains accruing or events happening after June 23rd 2010.

Transitional provisions contained in Schedule 1 paragraphs 18 - 22 are very important in the context of offshore trusts and companies.

1.2 The New Rates

The new Taxation of Chargeable Gains Act 1992 section 4 provides:

> "4 Rates of capital gains tax
>
> (1) This section makes provision about the rates at which capital gains

1 Chairman of the Revenue Bar Association 2001-05, Bencher of the Middle Temple, Fellow and Council Member of the Chartered Institute of Taxation, Chartered Tax Adviser, TEP. Author of Non-Resident Trusts (9th edition forthcoming), The Taxation of Trusts 2010 (published by Key Haven June 2010) and The Taxation of Foundations (published by Key Haven 2010), Inheritance Tax Planning and numerous other works on trusts and tax.

2 That relief has been extended and modified by Finance (No 2) Act 2010. The relief is outside the scope of this article.

tax is charged, but is subject to section 169N (rate in case of claim for entrepreneurs' relief).[3]

(2) Subject to the following provisions of this section, the rate of capital gains tax in respect of gains accruing to a person in a tax year is 18%.

(3) The rate of capital gains tax in respect of gains accruing to—

(a) the trustees of a settlement, or

(b) the personal representatives of a deceased person,

in a tax year is 28%.

(4) If income tax is chargeable at the higher rate or the dividend upper rate in respect of any part of the income of an individual for a tax year, the rate of capital gains tax in respect of gains accruing to the individual in the year is 28%.

(5) If no income tax is chargeable at the higher rate or the dividend upper rate in respect of the income of an individual for a tax year, but the amount on which the individual is chargeable to capital gains tax exceeds the unused part of the individual's basic rate band, the rate of capital gains tax on the excess is 28%.

(6) For the purposes of subsection (5), gains which are chargeable to capital gains tax at the rate in section 169N(3) are to be treated as forming the lowest part of the amount on which an individual is chargeable to capital gains tax."

RV Note: This is beneficial to the Revenue.

"(7) The reference in subsection (5) to the unused part of an individual's basic rate band is a reference to the amount by which the basic rate limit exceeds the individual's Step 3 income.

(8) For the purposes of this section, "the Step 3 income" of an individual means the individual's net income less allowances deducted at Step 3 of the calculation in section 23 of ITA 2007 for the purpose of calculating the individual's income tax liability.

(9) Section 989 of ITA 2007 (the definitions) applies for the purposes of this section as it applies for income tax purposes."[4]

1.3 Losses Realised by Individuals in 2010/11

The new Taxation of Chargeable Gains Act 1992 section 4B provides:

---

3 RV Note: I do not in general discuss entrepreneur's relief.

4 RV Note: I do not discuss the new section 4A Taxation of Chargeable Gains Act 1992 which concerns certain special cases.

> "4B Deduction of losses etc in most beneficial way
>
> (1) This section applies if the gains accruing to a person in a tax year are (apart from this section) chargeable to capital gains tax at different rates.
>
> (2) Allowable losses may be deducted from those gains, and the exempt amount under section 3 may be used in respect of those gains, in such way as is most beneficial to that person.
>
> (3) Subsection (2) is subject to any enactment which contains a limitation on the gains from which allowable losses may be deducted."

Thus, in general, one is permitted to set a loss or one's annual exemption against gains taxable at a higher rate before gains taxable at a lower rate.

See below for imputed gains of offshore trusts and companies.

1.4 Gains of Persons Temporarily Non-UK Resident

If a person is "temporarily" neither resident nor ordinarily resident in the United Kingdom gains accruing to him during years of absence from the United Kingdom can be deemed, by Taxation of Chargeable Gains Act 1992 section 10, to accrue to him in the year of return.

Schedule 1 paragraph 19 provides:

> "Gains treated as accruing to an individual under section 10A of TCGA 1992 (temporary non-residents) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing before 23rd June 2010."

Thus, all such gains will be charged to tax at a maximum rate of 18%, no matter what the rate of tax would have been had the individual been United Kingdom resident in the year in which the gain actually accrued to him.

1.5 Foreign Domiciliaries Taxable on the Remittance Basis

Schedule 1 paragraph 20 provides:

> "20 (1) Chargeable gains treated as accruing to an individual under section 12(2) of TCGA 1992 (non-UK domiciled individuals to whom remittance basis applies) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing on the day the related foreign chargeable gains are remitted.
>
> (2) For the purposes of sub-paragraph (1), foreign chargeable gains under section 809J of ITA 2007 (section 809I: order of remittances) in the tax year 2010-11 are to be treated as remitted before 23rd June 2010."

Paragraph 20(1) standing by itself favours the Revenue: the rate of tax depends on the date the gain is realised but on the date of remittance (which cannot be earlier than the date of realisation).

What is the effect of paragraph 20(2)? Does it mean that any gain remitted in 2010/11 is deemed to be remitted before 23rd June 2010 and thus chargeable at a maximum of 18%? That involves a detailed consideration of the way in which Income Tax Act 2007 section 809I (Remittance basis charge: income and gains treated as remitted) and section 809J (Section 809I: order of remittances) operate and interact, which is beyond the scope of this article.

2 Gains Imputed under Taxation of Chargeable Gains Act 1992 Section 86

2.1 Background

Taxation of Chargeable Gains Act 1992 section 86 can operate to deem certain gains realised by the trustees of non-UK resident settlements to be those of the settlor in the year in which they arise.

2.2 Gains Accruing During 2010/11

Schedule 1 paragraph 21 provides:

> "Chargeable gains treated as accruing to a settlor under section 86(4)(a) of TCGA 1992 (attribution of gains to settlors with interest in non-resident or dual resident settlements) in the tax year 2010-11 are to be treated for the purposes of this Schedule as accruing before 23rd June 2010."

Thus, such imputed gains are taxable at a maximum rate of 18%, no matter when they arise.

2.3 Planning

It may thus be advantageous if gains are deemed to be those of the settlor under section 86. For they will then not fall within section 87. That could result in their being taxed at the old rates rather than the new rates. See 1.7.

Can one make an offshore trust a section 86 trust? The answer is "yes, in principle, provided the settlor is alive and United Kingdom domiciled at some time in the year and United Kingdom resident or ordinarily resident in the year". This can be done even if the Settlor and any designated person is excluded from benefit. Care will need to be taken not to bring into play any other anti-avoidance provisions, such as the inheritance tax gifts with reservation of benefit provisions, the Income Tax (Trading and Other Income) Act 2005 Settlement Provisions or the Transfer of Assets Abroad Provisions.

3 Gains Imputed under the Offshore Beneficiary Provisions (Taxation of Chargeable Gains Act 1992 Section 87 - - 98A)

3.1 The Offshore Beneficiary Provisions

Taxation of Chargeable Gains Act 1992 sections 87 - 98A (and Schedules 4B and 4C) can result in gains realised by non-UK resident trustees being imputed to "beneficiaries" who receive (or who are deemed to receive) "capital payments" from the trustees. In essence, trust gains are matched with capital payments on a yearly basis and capital gains imputed accordingly.

If total trust gains exceed total capital payments, whether of the current year or unmatched ones carried forward from earlier years, then so much of the trust gains as equal the capital payments will be imputed to beneficiaries. If total capital payments exceed total trust gains , whether of the current year or unmatched one carried forward from earlier years, then so much of the trust gains as equal the capital payments will be imputed to beneficiaries.

Thus it is of the essence of the process that no trust gain can normally be imputed to any beneficiary until the end of a year of assessment. Had no special provision been made, all gains imputed for 2010/11 would have been deemed to arise at the end of that year and thus been taxable at the new rates.

3.2 The Transitional Rule

Schedule 1 paragraph 22 provides:

> "22 (1) This paragraph makes provision, for the purposes of this Schedule, in relation to—
>
> (a) chargeable gains treated as accruing to a beneficiary of a settlement under section 87(2) of TCGA 1992 (non-UK resident settlements: attribution of gains to beneficiaries) in the tax year 2010-11,
>
> (b) chargeable gains treated as accruing to a beneficiary of a settlement under section 89(2) of that Act (migrant settlements etc) in that tax year, and
>
> (c) chargeable gains treated as accruing to a beneficiary of a relevant settlement under paragraph 8(1) of Schedule 4C to that Act (attribution of Schedule 4C gains to beneficiaries) in that tax year.
>
> (2) Such of the chargeable gains within sub-paragraph (1)(a), (b) or (c) as result from the matching of capital payments received before 23 June 2010 are to be treated as accruing before that date.
>
> (3) Such of the chargeable gains within sub-paragraph (1)(a), (b) or (c) as result from the matching of capital payments received on or after that date are to be treated as accruing on or after that date.

(4) The reference in sub-paragraph (1)(b) to section 89(2) of TCGA 1992 is to be read as including a reference to that section as applied by section 90(6)(a) of that Act (transfers between settlements)."

What, therefore, is crucial, is when the capital payment was made, not when the trust gain was realised. It means that:

(a) a trust gain realised in 2010/11 before June 24th 2010 can be taxed at the new rates and

(b) a trust gain realised in 2010/11 after June 23rd 2010 can be taxed at the old rates.

The result is paradoxical but clear.

Illustrations

Capital Payment Received Before June 24th 2010 (whether or not in 2010/11)

Matched with Trust Gain arising before April 6th 2011: old rates

Matched with Trust Gain Arising post April 5th 2011: new rates

Capital Payment Received Post June 23rd 2010 (whether or not in 2010/11):

Matched with Trust Gain arising at any time: new rates

3.3 Trustees' Losses

Trustees' losses go to reduce the pool of trust gains for a year of assessment. Hence, they can determine whether and, if so, in which year a gain is imputed to a beneficiary.

Losses realised by trustees in 2010/11 can reduce the trust gains for 2010/11 and can thus postpone the year in which there is imputed a gain to a beneficiary who has received a capital payment from the trustees.

Where the capital payment has been received by the beneficiary prior to June 24th 2010, losses realised at any time in 2010/11 could result in trust gains being imputed to him in a year later than 2010/11 and thus being taxable at a higher rate.

3.4 Personal Losses

Losses of the beneficiary cannot be offset against gains imputed under the Offshore Beneficiary Provisions: Taxation of Chargeable Gains Tax Act 1992 section 2(4).

3.5 Planning

Where a beneficiary has received a capital payment before June 24th 2010. the trustees should consider

(a) realising gains in 2010/11 and / or

(b) postponing realising losses in 2010/11

if thereby the gain which is attributed to a beneficiary is taxable at a lower rate.

Trustees should think twice before paying or transferring settled property, whether to a beneficiary or to the trustees of another settlement, if that means that the trust will come to an end at a time when excess capital payments have been made. For capital gains realised by the recipient beneficiary or trustees in future may be taxable at a higher rate.

3.6 Planning: Interaction with Finance Act 2008 Schedule 7 Paragraph 126 election.

Where there is a beneficiary who is resident or ordinarily resident in, but domiciled outside, the United Kingdom, and the trustees have made, or can still make, a paragraph 126 election, care will be needed to obtain the optimum position.

4 Gains of Non-UK Resident Companies Apportioned under Taxation of Chargeable Gains Tax Act 1992 Section 13

4.1 Taxation of Chargeable Gains Tax Act 1992 section 13 operates by deeming certain capital gains which accrue to certain non-UK resident companies to their participators (or sub-participators).

4.2 The General Rule

Schedule 1 contains no special provisions relating to section 13. In the simple case where there is apportioned to a United Kingdom taxpayer only gains realised by one or more offshore companies, the position is straightforward. The imputed gain is deemed to be realised on the day on which the actual gain was realised by the company. See section 13(2) which provides:

> (2) Subject to this section, every person who *at the time when the chargeable gain accrues to the company* is resident or ordinarily resident in the United Kingdom and is a participator in the company, shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him."[5]

4.3 Losses of Offshore Companies

In certain cases a loss of an offshore company can be offset against a gain imputed to a person under section 13. Section 13(8) provides:

> "(8) So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person; and

5 Italics added by R.V.

> subject to the preceding provisions of this subsection this section shall not apply in relation to a loss accruing to the company."

Suppose that a section 13 company realises Gain A in May 2010 and Gain B in March 2011, both of which are imputed in their entirety to a Taxpayer, T. Suppose it realises a loss in March 2011 and the loss can be utilised by T under section 13(8). Can T elect to set the loss off against Gain B rather than Gain A, thus potentially reducing the amount of capital gains tax he is liable to pay?

Whatever the answer, it would seem that it would not matter if the loss had been realised between April 6th and June 23rd 2010.

Does the new Taxation of Chargeable Gains Tax Act 1992 section 4B (Deduction of losses etc in most beneficial way) help? The section certainly applies in principle as "the gains accruing to a person in a tax year are (apart from this section) chargeable to capital gains tax at different rates."

Is subsection (2) in point? It provides:

> "(2) Allowable losses may be deducted from those gains ... in such way as is most beneficial to that person."

Is the loss which is imputed under section 13(8) an "allowable loss"?

The nearest one comes to the definition of "allowable loss" is in Taxation of Chargeable Gains Tax Act 1992 section 16 (Computation of losses), which provides:

> "(1) Subject to sections 261B, 261D and 263ZA and except as otherwise expressly provided, the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed.
>
> (2) Except as otherwise expressly provided, all the provisions of this Act which distinguish gains which are chargeable gains from those which are not, or which make part of a gain a chargeable gain, and part not, shall apply also to distinguish losses which are allowable losses from those which are not, and to make part of a loss an allowable loss, and part not; *and references in this Act to an allowable loss shall be construed accordingly*.
>
> ..."[6]

In my view, a loss imputed under Taxation of Chargeable Gains Tax Act 1992 section 13(8) is an "allowable loss" and thus falls within the new section 4B. Hence, the loss can be set-off against the gain accruing after June 23rd 2010 in preference to one accruing before June 24th 2010.

---

6 Italics added by R.V.