CAPITAL GAINS TAX AND OFFSHORE TRUSTS

Rory Mullan[1]

Under UK law a territorial principle of taxation is in many instances expressly overridden by anti-avoidance provisions. Such provisions often operate to reverse tax-savings which might otherwise accrue by the use of offshore entities and typically do so by imposing charges on the potential or actual beneficiaries of the planning.

The scope and enforceability of such provisions is, however, becoming increasing questionable. In recent years The European Court of Justice (CJEU) has developed a coherent body of case law as to how the EU treaties and in particular the freedoms of movement interact with Member States' tax systems. As EU law now stands, deviations from the territoriality principle, that is to say taxation on a basis other than residence or source, are becoming increasingly difficult for states to rely on.

The EU law issues concerning anti avoidance provisions such as the taxation of assets abroad provisions (section 720 ITA 2007) and the charge to capital gains tax on participators in non-resident 'close' companies (section 13 TCGA 1992) have received a good deal of consideration. Indeed infringement proceedings have been brought by the European Commission in respect of them, resulting in a consultation and proposed changes to the legislation. In contrast, however, the position concerning capital gains tax provisions affecting offshore trusts and in particular the charges under sections 86 and 87 TCGA have been less widely discussed.

In this article it is proposed to consider some of the EU law issues which arise in the context of the capital gains tax charges affecting offshore trusts, those being

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the charge on settlors in section 86 TCGA 1992 and the charge on recipients of capital payments in section 87 TCGA 1992.

Basic EU law principles[2]

The basic principle governing the interaction of EU law with a Member State's tax provisions is that, although provisions concerning direct taxation fall within the individual competence of each Member State of the EU, that competence must be exercised in compliance with EU law and in particular with the freedoms of movement laid down in the EU treaties.

This means that to comply with the freedoms of movement the tax system of a Member State cannot operate in a manner which has the effect of discriminating against taxpayers on grounds of nationality or otherwise restricting their exercise of the freedoms of movement. Most particularly, where a tax provision prohibits, impedes or renders less attractive the exercise of a freedom of movement then as a matter EU law it will be unenforceable as against a tax payer exercising relevant treaty rights[3], unless

a) that provision can be justified as pursuing a legitimate objective compatible with the EU treaties or is otherwise justifiable by overriding reasons in the public interest[4] and

b) it can be shown that the provision is a proportionate means of achieving the justification in a), in that it is both appropriate to achieving its aim and that it does not go further than necessary in so doing[5].

Having regard in particular to the possibility of justifying a tax provision, it is noteworthy that the CJEU has made clear that maintaining tax revenues is neither among the objectives stated in the Treaty nor an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty[6].

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2 For a fuller and more comprehensive analysis of the issues involved please see *The Interaction of EU Treaty Freedoms and the UK Tax Code,* Rory Mullan and Harriet Brown (Key Haven Publications, 2011)

3 C 311/08 *Société de Gestion Industrielle (SGI) v État belge* at paragraph 50 and 51

4 C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 41

5 C 524/04 *Test Claimants in the Thin Cap Group Litigation v IRC* [2007] STC 906 at paragraphs 82 and 83

6 C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 36

As such restrictive tax measures cannot be justified on the ground that a Member State's tax revenue would be reduced.

The only exception to that is where a Member State can show that the purpose and effect of the provision is to tax activities carried out in that Member State and that those activities would otherwise escape the charge to tax. The CJEU has recognised that such a provision can be justified on grounds of maintaining a balanced allocation of taxing power or preventing tax avoidance, but has made clear that in any event the measure will still need to be proportionate.

Settling assets on trust

An initial question which arises in the context of provisions which impose a charge to tax by reference to offshore trusts concerns the application of EU treaty freedoms to settlements. Unfortunately, this is a question which has not been fully answered, with most of the relevant case law concerning individuals or corporate entities.

Moreover, there are a number of different situations concerning offshore settlements which can give rise to different tax consequences and which may or may not involve the exercise of EU treaty freedoms. These include:

a) settling property on trust;

b) a change of trustees;

c) a change of residence of the trust;

d) transferring property between settlements;

e) advancing property to beneficiaries absolutely.

Having regard to such situations, it would seem that there are a number of freedoms which are potentially in point: establishment; capital and services. These are considered below.

Usefully from the point of view of the UK taxpayer, it would only seem necessary to show that the rights of *someone* as regards EU treaty freedoms have been impinged upon. It should not be necessary to show that the person with the disadvantageous tax treatment is the one whose right to free movement has been restricted[7]. As such, it is likely that in most situations concerning taxation of offshore trusts it will be possible to rely on EU law.

7 C 18/11 *HMRC v Philips Electronics Ltd*

Freedom to provide services

Where professional trustees are involved, they are undoubtedly providing a service, so that the prohibition on restrictions on provision of services in Article 56 TFEU will certainly be in point. This will not, however, be the case in relation to trustees who are not acting return for remuneration (although it is no bar that remuneration is payable from the trust fund rather than any recipient of services[8]). As this freedom protects both providers and recipients of services, it is equally available to settlors and beneficiaries as it is to the offshore trustees seeking to offer their services[9].

It is, however, likely that any restriction on the freedom to provide services will be secondary to the restrictions, if any, on other freedoms of movement are in point. The relevance of this freedom being applicable is that, since it will almost always be in point where there are professional trustees, and is only *not* in point where another freedom of movement *is* in point, then many of the arguments as to whether transactions affecting settlements involve the freedom of establishment or free movement of capital become otiose, save where the trustees are not within the EU.

Freedom of establishment

The right of establishment in article 49 TFEU and confers a right to participate on a stable and continuing basis in the economic life of another Member State[10]. It includes a right to set up and manage undertakings, and in that respect it would seem likely that a trust can be undertaking for the purposes of Article 49 TFEU. As to whether a settlor has exercised a right of establishment by setting up and managing a trust which is carrying on economic activity that is obviously dependent upon the degree of possible influence which is retained over the trust and also the level of economic activities undertaken by the trust.

Alternatively, in particular circumstances it is possible trustees could be exercising rights of establishment. There would seem to be no reason why trustees cannot rely on rights to freedom of establishment when acting as such (which would also be relevant where the residence of a trust is moved[11]). This was implicit in relation

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8 C 76/05 *Schwartz and Gootjes Schwartz*

9 C 56/09 *Zanotti* at para 26

10 C 55/94 *Gebhard* at paragraph 25

11 See in this respect, *C 371/10 National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond* where a change in central management and control of a company engaged the right to freedom of establishment.

to the foundation in *Walter Stauffer*[12], although in that case the position may have been made more straightforward by the foundation's legal personality. It is, nevertheless, noted that the CJEU had little difficulty treating trustees as a separate entity in the *Wellcome Trust*[13] case, albeit in a VAT context.

In either case, however, it will be necessary that the settlement is carrying on an economic activity which will often not be the case, particularly where the offshore settlement holds assets and does not actively manage them.

Movement of capital

The freedom which is likely to be of most relevance in the context of offshore trusts is that concerning movements of capital. This freedom is contained in article 63 TFEU. It prohibits restrictions on movements of capital both within the EU and between Member States and third countries. There is a wide overlap between the various freedoms and in that respect it is likely that the free movement of capital will be applicable in almost all circumstances where a settlement is made on trust and indeed is likely to be the most relevant freedom.

There is no definition of 'movement of capital' for the purposes of Article 63 TFEU although it is clear that it is given a wide interpretation. In construing the term it is clear that the CJEU will have regard to the Nomenclature in Annex I to Directive 88/361 as indicating the type of transaction which comes within the meaning of that term, while recognising the term itself is not exhaustive. The terms of the Nomenclature itself are expressed to have a wide application so that the capital movements listed are not to be interpreted narrowly or in a way which would apply to capital movements only to a limited extent.
In this respect it is stated:

> *The capital movements listed in this Nomenclature are taken to cover:*
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> - *all the operations necessary for the purposes of capital movements: conclusion and performance of the transaction and related transfers. The transaction is generally between residents of different Member States although some capital movements are carried out by a single person for his own account (e.g. transfers of assets belonging to emigrants),*
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> - *operations carried out by any natural or legal person, including operations in respect of the assets or liabilities of Member States or of other public administrations and agencies, subject to the provisions of Article 68 (3) of the Treaty*

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12 C 386/04 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften*

13 C 155/94 *Wellcome Trust Ltd v Customs and Excise Comrs* at, paragraph 32

This is expanded by the definitions in the Nomenclature:

> *Residents or non-residents*
>
> *Natural and legal persons according to the definitions laid down in the exchange control regulations in force in each Member State.*
>
> ...
>
> *Natural or legal persons*
>
> *As defined by the national rules.*

It can be seen that definitions laid down by the Member States themselves are relevant. In that respect, although exchange control regulations are no longer in force, it is noted that for capital gains tax purposes the trustees of a settlement are treated as if they were a single person.

Having regard to sections 86 and 87 TCGA 1992 it can be seen that for the purposes of that legislation there is a transfer of assets between what are regarded as two separate persons (the settlor and the trustee or the trustee and the beneficiary). Accordingly, given that trustees are treated as a separate person under the relevant national rules and given the wide interpretation which is to be given to the Nomenclature it seems likely that trustees in their capacity as such will be considered persons for the purposes of the Nomenclature, particularly as it applies to these provisions.

The Nomenclature includes a category of capital movement entitled "Personal capital movements" which includes the following within the term “movement of capital”:

> *A - Loans*
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> *B - Gifts and endowments*
>
> *C - Dowries*
>
> *D - Inheritances and legacies*
>
> *E - Settlement of debts by immigrants in their previous country of residence*
>
> *F - Transfers of assets constituted by residents, in the event of emigration, at the time of their installation or during their period of stay abroad*
>
> *G - Transfers, during their period of stay, of immigrants' savings to their previous country of residence*

This makes clear that the term movement of capital includes gifts and endowments as well as investments by a non-resident in another Member State. Movement of capital has also been held to include the transfer of immovable property by its sole owner to a private company in which the transferor holds all the shares[14] and as such, the fact that a settlor has an interest in a settlement should not prevent there from being a movement of capital.

Regard being had to the wide approach to interpretation of the Nomenclature and the inclusion of this category within the movements listed then I would suggest that settling property on trust must be a movement of capital. In this respect, it is noteworthy that the CJEU has decided that a gift to a Liechtenstein foundation of which the donor was the primary beneficiary was a movement of capital[15]. It would be consistent to adopt a similar approach to settling property on trust.

Similarly, an appointment or other transaction whereby a person becomes absolutely entitled as against the trustees to trust property (and capital payments to which section 87 TCGA 1992 applies) should also amount to a capital movement.

R (on the application of Shiner) v HMRC

A question as to the application of EU treaty freedoms to the settling property on trust is raised by the decision of the Court of Appeal in *R (on the application of Shiner) v HMRC*[16]. In that case the Court considered whether the provisions on free movement of capital applied in relation to the settlement of £10 in an Isle of Man resident trust. The trustees subsequently entered into a partnership, the retrospective taxation of which was argued to be contrary to Article 63 TFEU.

In his judgment at paragraph 53 Mummery LJ states that putting £10 into a trust "is not in itself a 'movement of capital' within the meaning of" Article 63 TFEU. This suggests that the Court of Appeal considers that settling property on trust is not a movement of capital.

Such an interpretation does, however, go further than the submissions by HMRC on the point (which were being accepted by Mummery LJ in this part of his judgment). Those submissions, as summarised in the judgment, were to the effect that there was no *relevant* movement of capital. That is to say, that even if the settling of £10 was a movement of capital, it was not a movement of capital which

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14 C 510/08 *Mattner v Finanzamt Velbert* [2010] All ER (D) at paragraphs 19 and 20

15 C 452/01 *Ospelt v Schŏssle Wesseberg Familier Stiftung*

16 [2011] STC 1978

was restricted by provisions which retrospectively taxed profits of a partnership subsequently carried on by the trust.

If Mummery LJ is taken as accepting the HMRC submissions, then no issue arises and that is clearly a conclusion he could properly have reached. To the extent, however, that Mummery LJ is going farther than this, it is difficult to see what justification there is for such an approach. Certainly, it appears to be deciding something which was not argued and which is expressed without reference to the Nomenclature.

It is difficult to see how a Court before which the wider issue was properly argued and which had the benefit of the Nomenclature would conclude that there is no capital movement. It is suggested that such a Court would be interpret the relevant passage from Mummery LJ's judgment as accepting HMRC's argument that there was not a relevant movement of capital although a reference to the CJEU would be more likely.

Limitations on the free movement of capital as it applies to third countries

Article 63 TFEU which concerns the free movement of capital applies both to movements between Member States and also to situations concerning third countries. It does not, however, apply in an identical manner in the two contexts. In this respect, although it is said that the provisions concerning free movement of capital apply to third countries in the same way as they apply to Member States[17], that is subject to two important caveats:

a) The legal relations between Member States and third countries is likely to be different to that which exists between Member States, and this can accordingly allow a Member State to justify a measure as against a third country which it could not justify as against an Member State[18].

b) Measures in place on 31 December 1993 will not be disapplied to the extent that they restrict movements of capital with third countries involving direct investment (the 'standstill')[19]. This will not apply where the measure has been changed to create a new restriction[20].

17 C 101/05 *A* at paragraph 31

18 C 72.09 *Rimbaud*

19 Article 64 TFEU and C 436/08 *Haribo*

20 C 446/04 *FII* at paragraph 194

In the context of section 86 and 87 TCGA 1992 it is likely only to be the standstill which is relevant. For reasons discussed below, it seems likely that the UK has lost the benefit of this provision. Nevertheless, it may still be relevant in the context of historic claims, particularly restitutionary claims which might be brought for unlawfully levied taxes.

Reliance on the free movement of capital can be excluded in certain circumstances where a provision is aimed primarily at a different treaty freedom, for example, the right of establishment[21]. This issue is discussed below in the context of sections 86 and 87 TCGA 1992.

Charging gains accruing to non-residents

The general rule is that persons who are not resident in the UK will not be subject to capital gains tax in respect of chargeable gains accruing on the disposals of assets wherever situate (TCGA 1992, s 2).

That is subject to a number of exceptions, including:

(1) temporary non-residents returning to the UK within five years (section 10A TCGA 1992),

(2) persons carrying on trade, profession of vocation in the UK through a branch or agency are liable on disposals of UK situate assets used for the trade or for the branch or agency (section 10 TCGA 1992), and

(3) the new charge on gains accruing to companies holding residential property.

In the case of trusts, the current position is that offshore trustees are not liable to capital gains tax on gains accruing on trust assets, but there are potential charges on settlors and beneficiaries of such trusts relating to gains on trust assets. Those charges are applied under sections 86 and 87 TCGA 1992[22].

UK resident trusts

As regards UK resident settlements, section 77 TCGA 1992 had imposed a charge to capital gains tax on settlors of UK resident settlements until it was repealed with effect from 6 April 2008. The charge only applied, however, if the settlor or his

21 C 31/11 *Scheunemann v Finanzamt Bremerhaven*

22 There is a parallel charge to that under section 87 TCGA 1992 under Schedule 4C TCGA 1992 which applies in certain circumstances. That is not considered in detail in this article.

spouse had an interest in the settlement. By contrast, as noted below the settlor charge under section 86 TCGA 1992 has much wider application.

Where section 77 TCGA 1992 did (or as is currently the case does) not apply, trustees are liable to capital gains. That was formerly the rate applicable to trusts in section 686 ICTA 1988, but in recent years has been 28%, the rate of capital gains tax applying to higher rate taxpayers (see generally section 4 TCGA 1992).

Section 86 TCGA 1992

Section 86 TCGA 1992 operates by imposing a charge on a UK resident and domiciled settlor of a trust, the trustees of which are non-resident, in any year in which the settlor has "an interest in the settlement". The charge is imposed by reference to the gains realised by the trustees of the settlement. An amount equal to those gains are deemed to accrue to the settlor.

A settlor for these purposes is any person from whom property in the settlement originates[23]. Circumstances in which property is taken to originate from a person include: where it is provided by that person; where it represents property provided by that person; where is income from such property; where is provided pursuant to reciprocal arrangements made by the person; and where it is provided by a company under the control of the person[24].

A settlor has an interest in a settlement for the purposes of the section if, broadly, a defined person may benefit under the settlement in any circumstances whatsoever[25]. This raises an important point as to the width of application of the section. In particular what is meant by a settlor having an interest in a settlement under section 86 is very different and much wider from similar expressions elsewhere in the UK tax code. The categories of persons falling within the description of defined person by reference to which a settlor is said to have an interest in the settlement is set out in paragraph 2(3) TCGA 1992:

> *(3) For the purposes of sub-paragraph (1) above each of the following is a defined person-*
>
> *(a) the settlor,*
>
> *(b) the settlor's spouse or civil partner;*

23 paragraph 7, Schedule 5 TCGA 1992

24 paragraph 8, Schedule 5 TCGA 1992

25 paragraph 2 of Schedule 5 TCGA 1992

(c) *any child of the settlor or of the settlor's spouse or civil partner;*

(d) *the spouse or civil partner of any such child;*

(da) *any grandchild of the settlor or of the settlor's spouse or civil partner;*

(db) *the spouse or civil partner of any such grandchild;*

(e) *a company controlled by a person or persons falling within paragraphs (a) to (db) above;*

(f) *a company associated with a company falling within paragraph (e) above.*

The effect of this is that if any person falling within this category can benefit then the charge applies. That includes, for example, a trust where a beneficiary is related to the settlor only by reason of being married to a grandchild of the settlor's spouse.

The application of sub-paragraphs (da) and (db) is restricted in relation to certain settlements created before 17 March 1998. This can be relevant in considering the standstill provision.

A qualifying settlement includes all settlements created on or after 19 March 1991. Settlements made before that date will also be qualifying settlements from 6 April 1999 unless they fall within a limited class of exceptions (paragraph 9, Schedule 5 TCGA 1992). Once again this is relevant in considering the operation of the standstill provision

The settlor has a right of of recovery in respect of tax charged under section 86 TCGA 1992 as against the trustees of the settlement[26] under UK law.

Section 87 TCGA 1992

The charge under section 87 TCGA 1992 was rewritten by FA 2008 with the relevant provisions now spread over section 87 to 87C TCGA 1992 and including a remittance basis charge.

Broadly, the section requires trust gains of the settlement, that is gains which would have accrued if the settlement were UK resident, to be calculated, and these

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26 Paragraph 6 of Schedule 5 TCGA 1992

are attributed to UK resident beneficiaries who receive capital payments (defined in section 97 TCGA 1992). The term trust gains is not included in the rewritten sections which refer to 'the section 2(2) amount'.

The changes in 2008 were intended to extend the scope of the charge by applying a remittance basis to non-UK domiciled beneficiaries.

A change which affected all beneficiaries was that capital payments were matched with the most recent trust gains in priority to gains made in earlier years (section 87A TCGA 1992). Under the previous approach earlier gains were matched with capital payments before later gains (section 92 TCGA 1992, now repealed).

Section 91 TCGA 1992 provides for an additional charge equal to 10 per cent of the tax for each year from when the gain matched to the capital payment was made for a maximum of six years, giving a current maximum rate of 44.8%.

Schedules 4B and 4C were introduced from 20 March 2000 to provide an essentially similar and parallel charge to the section 87 TCGA 1992 with extended scope in circumstances where there was a transfer of value linked with trustee borrowing. These provisions were intended as anti-avoidance provisions, and as such were intended to extent the scope of the charge on beneficiaries receiving capital payments.

Which treaty freedom applies?

Many trusts to which sections 86 and 87 TCGA 1992 are based in territories which are regarded as third countries for the purposes of the application of the EU treaty freedoms. While it is possible to rely on free movement of capital in relation to such territories, that right can be excluded in certain circumstances, one of which is where the restriction on the free movement of capital is secondary to and a consequence of the restriction on another Treaty freedom[27].

That leaves a question of whether the free movement of capital will be of primary relevance in the context of those provisions. In addressing that issue the proper approach is to consider the purpose of the legislation in question and then to consider the issue by reference to that freedom of movement the *rationae materiae* of which most closely relates to that purpose[28].

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27 see C-452/04 *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht* [2007] All ER (EC) 239

28 see C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] STC 906 at paragraphs 26 to 34

As neither provision is aimed at taxing active participation in economic activities in another Member State freedom of establishment is plainly not in point[29].

Moreover, although provisions which are directed at offshore trusts might be considered in the context of a restriction on the freedom to provide services, it would seem more likely that since they are aimed at taxing a settlor by reference to property originating from him or a beneficiary by reference to capital movements they are more properly dealt with in the context of the free movement of capital.

As such the free movement of capital should be available to be relied upon even in third country situations.

Restrictions on free movement of capital – section 86 TCGA 1992

The treaty provisions conferring rights to freedom of movement prohibit tax provisions which operate to restrict the exercise of those rights (unless such can be justified and is proportionate). There will be a restriction on the exercise of the right to free movement of capital where a person is placed at a disadvantage as a result of exercising that right, where she would not have been so disadvantaged if he had not exercised the right. In this respect, the legislation need only be capable of restricting the freedom of movement, and it need not be shown that it has actually done so[30].

There would seem to be little doubt that at present section 86 TCGA 1992 has a restrictive effect: it imposes a charge on a person, where such a charge would not arise in relation to a UK resident trust. That plainly amounts to a restriction on the right to free movement of capital. This can be seen from C-196/04 *Cadbury Schweppes plc v IRC*[31] where it was made clear that imposing a charge on a person which would not arise in a wholly resident context would amount to a restriction:

> *"That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account ... the fact referred to by the national court that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not*

29 see C-97/09 *Schmelz v Finanzamt Waldviertel* [2011] STC 88

30 See for example *Thin Cap* at paragraph 62

31 [2006] STC 1908 at paragraph 45

> *the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that member state which is not subject to a lower level of taxation."*

Although the tax charged under section 86 TCGA 1992 is subject to a right of reimbursement that does not cure the restrictive effect of the charge. It is an additional burden which would not arise if the trust was UK resident. A restriction on the right of free movement of capital therefore still exists.

An additional point is that it is not clear that the right is enforceable. It is a principle of international law that one state will not enforce the tax laws of another state[32], such that the indemnity, being an indirect tax charge, may not be enforceable. As such there is some doubt whether the right can be relied upon even if its existence could cure the discrimination any event.

Discrimination resulting from the application of section 86 TCGA 1992

An argument might be made that a restriction must exist at the time when the right to freedom of movement is exercised. Since some trusts will have been created before there was any charge under section 86 TCGA 1992 (and subsequent to that it might be said that by reason of section 77 TCGA 1992 the same charges would have arisen if the trusts were based in the UK) it might then be argued that there was no restriction at the time when property was settled and EU law cannot be relied upon subsequently.

Such an argument would, however, be an overly simplistic approach to the concept of restrictions on freedom of movement which is looking at the restrictive effects of the legislation rather than whether a restriction actually occurs. Nevertheless, as HMRC often adopt a mechanistic approach to considering the phraseology of the CJEU[33], it is useful to consider the matter by reference to whether the legislation can be considered as being discriminatory. It is perhaps more obviously the case when considering discrimination in relation to freedoms of movement, as compared to restrictions on freedoms of movement, that the compatibility of the

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32 see *Government of India, Ministry of Finance (Revenue Division) v Taylor* [1955] AC 491

33 See for example the arguments which were accepted by the Court of Appeal in *Test Claimants in the Thin Cap Group Litigation v Revenue and Customs Commissioners* [2011] STC 738 which focussed on interpreting the terminology of "commercial justification" without reference to the requirements of proportionality. For a fuller discussion see *Test Claimants in the Thin Cap Group Litigation v HMRC: what amounts to commercial justification in considering issues of proportionality?* Rory Mullan (2011) BTR, Issue 3, 295.

legislation with EU law is to be determined from time to time rather than when the movement occurs.

In this respect, the classic description of discrimination is that it involves treating persons in comparable situations differently or treating persons in different situations in the same way, in circumstances where such treatment cannot be justified by reference to the subject matter and purpose of the legislation[34].

Indirect discrimination by reference to residence

The prohibition on discrimination would be relied upon by a taxpayer in the context of the EU treaty freedoms is that relating to discrimination on grounds of nationality. Such discrimination is expressly prohibited[35].

Although sections 86 and 87 TCGA 1992 contain no direct reference to nationality so that there is no direct discrimination on grounds of nationality, there would nevertheless seem to be indirect discrimination on grounds of nationality. Such indirect discrimination occurs where the criteria of distinction leads to the same result as direct discrimination. In this respect, residence has been recognised as giving rise to potential indirect discrimination on grounds of nationality[36]. That is because most residents of a state are likely to be nationals of that state, while non-residents are likely to be non-nationals. Similarly with trusts, indirect discrimination on grounds of nationality might be established by reference to residence of trustees, on the basis that non UK resident trustees will predominantly be non-UK nationals.

Treating residents and non-residents differently

It is worth noting, however, that Article 65 TFEU expressly permits in the context of the free movement of capital a difference in treatment between residents and non-residents. That might be said to permit a different treatment for trusts where the trustees are non-resident:

> *1. The provisions of Article 63 shall be without prejudice to the right of Member States:*

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34 See for example C-279/93 *Finanzamt Köln-Altstadt v Schumacker* [1995] STC 306 at paragraph 30

35 Article 18 TFEU contains a general prohibition, but the freedoms of movement are taken to be specific statements of this prohibition within the scope of the respective articles, with the consequence that where free movement of capital is in point, the prohibition on discrimination falls within Article 63 TFEU rather than Article 18 TFEU.

36 See C-240/10 *Schulz-Delzers and another v Finanzamt Stuttgart III* [2011] STC 2144

> (a) *to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;*
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> (b) *to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.*
>
> …
>
> 3. *The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63.*

Nevertheless, although the wording of Article 63 TFEU might suggest a freedom to treat residents and non-residents differently, the approach of the CJEU to the interpretation of this Article suggests that it is irrelevant to the question of whether there discrimination on grounds of nationality. It has been made clear that insofar as this provision might amount to a derogation from the principle of the free movement of capital then it is to be interpreted strictly. In particular it cannot be construed to mean that all tax legislation which draws a distinction between taxpayers based on their place of residence or the Member State in which they invest their capital will automatically be compatible with the Treaty[37].

In this respect, the prohibition on arbitrary discrimination in Article 63(3) TFEU is important. That prohibition has been taken to qualify Article 63(1) TFEU so that it cannot apply to permit a difference in treatment based by reference to persons who are in comparable situations, that is to say that it cannot permit discrimination. A difference in treatment must be capable of being legitimately justified by reference to differences in the situations of residents and non-residents.

The approach permitted under Article 65 TFEU is the same as that which is permitted under the other freedoms of movement: residents and non-residents can be taxed on a different basis provided that they are not in comparable situations or they can be taxed in the same way provided that they are in the same position.

37 See C 11/07 *Eckelkamp v Belgische Staat* [2008] ECR I-6845 at para 57

Alternatively it must be shown that there is an overriding reason in the general interest which shows that the provision should not be regarded as discriminatory.

Discriminatory effects of the legislation

Section 86 TCGA 1992 imposes a tax charge on a settlor where the trust is not resident in the UK, but does not impose such a charge where it is so resident. Furthermore, even when section 77 TCGA 1992 was in force, the scope of the charge on settlors was much more limited. The charge only applied if the settlor or his spouse had an interest in the settlement. By contrast, the settlor charge under section 86 TCGA 1992 had much wider application.

In circumstances where a charge would not be imposed on the settlor of a UK resident trust but is imposed on the settlor of a non-resident trust, either because of the wider application of section 86 TCGA 1992 or from 6 April 2008 because of the repeal of section 77 TCGA 1992 then the situation would seem to be *prima facie* discriminatory. The settlor is placed in a worse situation by reason of having exercised his right to freedom of movement.

Treating persons in different situations the same

Even if the right to an indemnity is enforceable and the administrative difficulties could be ignored and it could somehow be said that sections 86 and 77 TCGA 1992 should be treated as operating in a similar manner, that would at best only improve the situation to treating persons in different situations the same (rather than treating the non-resident worse). There is still, however, discrimination: the less commonly applied limb of the discrimination test is that which relates to persons who are in different situations being treated in the same way and that would be very much in point.

Trustees who are resident in the UK and those who are resident offshore are in very different situations. On established principles of international law (which have been recognised on numerous occasions by the CJEU in relation to the justification for restrictive tax practices based upon the balanced allocation of taxing power[38]), the offshore trustees will be within the taxing jurisdiction of the country in which they are resident. By contrast, the UK based trustees will not be within the foreign jurisdiction. That is a very relevant difference in situation which should have the consequence that the different trusts should be treated differently.

38 See for example C 371/10 *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond*

It would seem to follow that the UK legislation unlawfully discriminates in the situation where it indirectly taxes offshore trusts by imposing a charge on the settlor, even in circumstances where such charge is also imposed on the settlor of a UK resident trust. The fact that the persons are not in similar situations can be seen in that an objective of not losing tax revenue to offshore jurisdictions would not be recognised as legitimate (as discussed below)[39].

Restrictions on free movement of capital – section 87 TCGA 1992

As regards section 87 TCGA 1992, there is clearly a restriction on free movement of capital. A capital payment within the meaning of that section gives rise to a charge to capital gains tax in circumstances where a similar payment from a trust which has always been UK resident will not. That is a clear restriction which does not require an analysis by reference to discrimination.

Justifications and comparability

Establishing that legislation restricts the exercise of the right to free movement of capital is not the end of the matter. As noted above legislation might still be justified as pursuing a legitimate objective compatible with the EU treaties or is otherwise justifiable by overriding reasons in the public interest[40] and it can be shown to be proportionate.

Similar issues arise in relation to determining whether discrimination exists. In addressing the question of whether persons being treated differently are in comparable situations or whether persons being treated in the same way are in different situations such as to amount to discrimination it is necessary to consider the purpose and objectives of the legislation. If those purposes and objectives represent a legitimate aim, then either the treatment is stated not to amount to discrimination because situations are not comparable, regard being had to the reasons for difference in treatment or the treatment is said to be justified.

In the tax context the CJEU has recognised a number of justifications which apply to permit apparently discriminatory or restrictive tax measures which require consideration. A starting point, however, is that preventing a reduction in tax revenue is not a legitimate aim capable of justifying such measures[41]. Since that is

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39 Similar considerations apply to the settlements legislation

40 C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 41

41 See C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 46

plainly the objective of the legislation under consideration that raises an immediate problem for the UK government.

Balanced allocation of taxing power

The principle that preventing a reduction in tax does not justify impinging upon treaty freedoms is limited to an extent by the increasing recognition that ensuring a balanced allocation of powers of taxation is a legitimate objective. The CJEU has recognised that Member States should be permitted to tax profits properly falling within their taxing jurisdiction (generally recognised by reference to the territorial principle of taxation) even where a charge results in restriction on the right to free movement of capital. For example in *National Grid Indus*[42] the CJEU recognised the right of the Netherlands to tax capital gains of a company which were realised while that company was resident in the Netherlands, referring to "its right to tax a capital gain which arose within the ambit of its powers of taxation".

It is doubtful, however, that such a justification could have been used to tax gains which the CJEU considered to fall outside the ambit of its powers of taxation, which in the context of that case would have related to gains which were realised by a non-resident. In that respect, it is noted that this justification wasn't recognised in relation to the UK's attempts to tax the profits of a controlled foreign company in *Cadbury Scheweppes*, such profits arising to a non-resident it was plain that they did not fall within the ambit of the UK's taxiing powers.

Similarly, therefore it is difficult to see how this justification could be prayed in aid of sections 86 and 87 TCGA 1992 the purpose of which are to tax capital gains accruing to non-residents. That is most obviously the case where those gains arose in respect of assets situate outside the UK.

A justification might be made for assets situate in the UK on the persons to whom the gain arises, but that is not what section 86 and 87 TCGA 1992 do, and even if they were sought to be justified by reference to the right to tax such gains, it is difficult how they could possibly be considered a proportionate means of achieving that objective.

Maintaining fiscal coherence

A related justification is that which is sometimes referred to as maintaining the fiscal coherence of a taxing system. This justification has been employed on occasion to permit Member States to adopt tax measures which on a narrow view

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42 C 371/10 *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond*

appear restrictive or discriminatory, but which when viewed in a wider context apply a treatment to situations with a foreign element which is broadly similar to that which applies to wholly internal situations.

For example, in *FII*[43] the CJEU was prepared to accept that a system which taxed foreign dividends but not domestic dividends was not contrary to the treaty freedoms because when viewed in the round, the economic profits suffered the same taxation (although it has more recently confirmed that there would be a restriction where the tax levels were in fact different). In the domestic situation tax was applied at the underlying corporate level and not at the dividend level, whereas in the foreign situation tax was applied at the dividend level but not at the corporate level. Provided the overall rates where the same, the two situations where comparable and there was not discrimination.

While it is difficult to see how this would apply to section 86 TCGA 1992, it is not inconceivable that a similar argument could be employed in relation to the charge under section 87 TCGA 1992. It might be argued that having a charge on a capital payment of a UK resident beneficiary of an offshore trust puts that beneficiary in a comparable situation to if she had received the capital payment from a UK resident trust. In both instances the payment represents a sum which represents some element of a gain, and the effect of the charge is to ensure that such gain has suffered capital gains tax. The difference would be that in the situation involving the offshore trust, the charge is at the point of payment rather than at the time the gain was realised.

While such a justification might be raised, it is noteworthy that it would not apply to certain elements of the charge under section 87 TCGA 1992 most notably the surcharge under section 91 TCGA 1992. It is also noteworthy that the straightforward principle which was accepted in *FII* required a further reference in which the scope of this limitation was limited[44].

Tax avoidance

It is difficult to see how the justification based upon tax avoidance as developed by the CJEU could be relied upon by the UK in respect of either of sections 86 or 87 TCGA 1992. That justification depends upon wholly artificial arrangements which do not reflect economic reality designed to circumvent the legislation which would

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43 C-446/04 *Test Claimants in the FII Group Litigation v IRC* [2007] STC 326

44 C-35/11 *Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2012] All ER (D) 229 (Nov)

otherwise tax activities carried out in the UK[45]. Simply setting up genuine arrangements which have the effect of bringing gains outside the scope of the charge to capital gains tax would is not the type of activity falls within this ground of justification.

Fiscal supervision

It has been stated that an exercise of a right to freedom of movement involving a third country takes place in a different legal context such that a different analysis might apply[46]. In that respect, the CJEU has allowed restrictions relating to third countries based upon maintaining effective fiscal supervision in circumstances where such restrictions are not permitted intra-EU. The reason for this is the absence of agreements with third countries providing for exchange of information.

A possible absence of information as to trust gains cannot justify the charge under section 86 or 87 TCGA 1992. Those very charges depend upon information being provided to HMRC and imposing a charge cannot be said to protect the UK revenue from a lack of information.

However, an argument might be made that charging a settlor, HMRC are able to effectively enforce liability on gains accruing to offshore trustees. When taken with provisions concerning balanced allocation of taxing powers this might permit an argument that section 86 TCGA 1992 is justified insofar as it relates to the charge on gains on UK situs properties. Such an argument could only succeed in relation to third countries, however, as the CJEU would hold that there is machinery to impose the charge on offshore trustees within the EU.

Proportionality

As noted above, where legislation can be justified as pursuing a legitimate aim, it must nevertheless be shown that the legislation is a proportionate means of achieving that aim. A provision will be proportionate if it is appropriate to achieve its aim and also does not go beyond what is necessary to achieve that aim. Proportionality arguably also requires that the provision is reasonable.

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45 See *Cadbury Schweppes* at paragraph 55

46 see Case C72/09 *Établissements Rimbaud SA v Directeur général des impôts* [2010] STC 2757 at paragraph 40

Section 86 TCGA 1992

As noted the only likely justification in relation to section 86 TCGA 1992 would be in the context of the balanced allocation of taxing power perhaps taken with ensuring fiscal supervision which might permit taxation of the offshore trustees on gains arising on UK situate assets. Section 86 TCGA 1992 applies on a much wider basis than simply UK resident assets and does not charge the person to whom the gain accrues. In that respect, it is manifestly inappropriate and plainly goes further than necessary. In those circumstances, it is difficult to see how the UK could resist an argument that section 86 TCGA 1992 is contrary to EU law in its entirety.

Where a third country (that is to say, not a Member State) is involved and fiscal supervision argument was made in conjunction with balanced allocation of taxing power then clearly section 86 would once again go farther than necessary by taxing all gains. There would, however, be a risk of a conforming interpretation by a UK court.

Section 87 TCGA 1992

In relation to the section 87 TCGA 1992 charge, a potential justification is that it

aims to put beneficiaries of an offshore resident trust in a comparable position to beneficiaries of a UK resident trust, that is to say that capital payments should be subject to capital gains tax to the extent that they payment represents a chargeable gain. While an argument can be made for such a justification to apply there are a number of areas where it plainly goes beyond the requirements of proportionality:

(i) *Section 91 TCGA 1992*

The additional charge under section 91 TCGA 1992 cannot be said to not go beyond what is necessary to achieve the aim of the legislation. The only justifiable aim of the charge is to put beneficiaries in a similar position regardless of where the trust is established. The section 91 TCGA 1992 charge puts the beneficiary of the offshore trust in a worse position and as such it would fail the requirement of proportionality.

(ii) *Attribution of trust gains to capital payments*

The approach of attributing all of the trust gains to a capital payment goes further than is necessary to achieve the aim of the legislation. Insofar as gains are attributed to a beneficiary and they relate to a fund in which the beneficiary has no interest, then it is difficult to see how the charge can be described as appropriate.

(iii) *The matching rules*

It is arguable that in treating all of a capital payment as representing trust gains, that is the matching rules, goes farther than necessary to achieve the justifiable aim of the legislation. There would seem to be a reasonable argument that gains should be attributed to capital payments in proportionate manner. For example if a beneficiary is paid £50 out of a £100 fund of which £40 represents trust gains, the trust gains attributed to him should be £20 (i.e. 40 x 50/100) rather than £40.

(iv) *Foreign taxes*

Another point is that in order to put the beneficiary of the offshore trust in a comparable position to the beneficiary of the UK trust, credit would need to be given for any foreign capital gains tax suffered. That is in line with the approach in *FII*. The UK legislation does not expressly address this.

Having regard to these points, although there is a possibility of arguing a justification in relation section 87 TCGA 1992 it is plain that there are significant issues with proportionality and as such there are significant questions as to whether the charge could be held to apply as a matter of UK law.

The standstill provision

An issue which arises in the context of movements of capital between Member States and third countries concerns the standstill provision which permitted Member States retain provisions which restrict movements of capital and were in place before 1 January 1994. Article 64(1) TFEU provides:

1. *The provisions of Article 63 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries involving direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets. In respect of restrictions existing under national law in Bulgaria, Estonia and Hungary, the relevant date shall be 31 December 1999.*

Since this is a derogation from the basic principle of the free movement of capital it is interpreted strictly. In that respect, for restrictions to be 'restrictions which exist on 31 December 1993' the relevant legal provision relating to the restriction must have formed part of the legal order of the Member State concerned continuously since that date.

Member States can adapt existing legislation provided that they do not alter the existing legal situation. If changes amount to a new restriction a Member State will lose the ability to rely on the Article. In this respect it was stated by the CJEU in *FII*[47] that:

> *"... any national measure adopted after a date laid down in that way is not, by that fact alone, automatically excluded from the derogation laid down in the Community measure in question. If the provision is, in substance, identical to the previous legislation or is limited to reducing or eliminating an obstacle to the exercise of Community rights and freedoms in the earlier legislation, it will be covered by the derogation. By contrast, legislation based on an approach which is different from that of the previous law and establishes new procedures cannot be regarded as legislation existing at the date set down by the Community measure in question".*

The Court of Appeal in *FII* identified the restriction on freedom of movement and analysed whether there had been any change in that restriction[48]. Peripheral changes which had an indirect effect on what was occurring were not considered to be relevant.

Changes to section 86 TCGA 1992

The application of section 86 TCGA 1992 has been expanded since 1 January 1994. In particular:

(i) a parallel charge in the case of temporary non-residence was introduced by section 86 A TCGA 1992;

(ii) gains under section 13 TCGA 1992 are attributed to trustees where they are participators, and not merely where they are shareholders (paragraph 1(3), Schedule 5 TCGA 1992);

(iii) the class of defined persons has been extended to include grandchildren and their spouses. That is an extension to the restriction on freedom of movement (paragraph 2(3), Schedule 5 TCGA 1992).

Furthermore, the application of section 86 TCGA 1992 to settlements created before 19 March 1991 has been significantly expanded[49]. Before 31 July 1998 all

47 at paragraph 192

48 paragraphs 71 to 88

49 paragraph 9, Schedule 5, TCGA 1992

settlements created before 19 March 1991 escaped the charge unless one of a number of conditions[50] were satisfied. Since 31 July 1998 that has only been the case where the class of beneficiaries has been limited, so far as they are defined persons, to minors and unascertained persons[51]. That significant extension of the restriction.

Given the extension of the charge under section 86 TCGA 1992, it is likely that there has been an extension of the restriction and/or discrimination such that HMRC would not be in a position to rely on the Article to defend a claim for repayment of tax paid.

Changes to section 87 TCGA 1992

As regards section 87 TCGA 1992 there have been a number of changes. Those which are of relevance in relation to capital payments made before 2008/09 include the following:

(i) the extension of the charge to settlements created by non-UK domiciled settlors as from 1997/98;

(ii) the withdrawal if indexation allowance and the inclusion of provision preventing taper relief from applying from 1998/99;

(iii) the introduction of Schedules 4B and 4C from 20 March 2000.

More significant changes were introduced in 2008/09 with the rewriting of section 87 TCGA 1992 to apply the charge to non-UK domiciled beneficiaries. That was accompanied by a change in the matching rules, although that would not necessarily be disadvantageous.

Given that the CJEU has made clear that "legislation based on an approach which is different from that of the previous law and establishes new procedures cannot be regarded as legislation existing at the date set down by the Community measure in question"[52] then the standstill in Article 64(1) can no longer apply to section 87 TCGA 1992. That is certainly the case from 6 April 2008 and there would seem a good argument as regards the position from 20 March 2000.

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50 in paragraph 9(3) to (6), Schedule 5 TCGA 1992

51 paragraph 9(10A) to (10D), Schedule 5 TCGA 1992

52 *FII* above

Direct investment

In addition, it is to be noted that Article 64 TFEU is expressed to apply to "*direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets*". In *Haribo*[53] it was held that the derogation did not apply where the capital movement did not involve direct investment. Having regard to the Nomenclature, Direct Investment means investments which establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available. It is not clear that this would apply to settling property on trust, and it is very difficult to see how it would apply to an appointment out of a trust such as is charged under section 87 TCGA 1992.

Conclusion

There are significant issues with section 86 and 87 TCGA 1992 and in their current form they are almost certainly incompatible with EU law. This applies not only to trusts resident on Member States but to trust resident anywhere in the world, in relation to which the UK taxpayer can rely on the free movement of capital.

While there are some potential justifications from an EU law perspective for a charge which applies on broadly similar principles to section 86 and 87 TCGA 1992, it is plain that such charge would need to be much more narrowly drawn. To the extent that those justifications could be raised in relation to section 86 and 87 TCGA 1992 it is plain that those sections are a disproportionate means of achieving any legitimate aim which might be identified, and for that reason would again be incompatible with the free movement of capital.

53 *Haribo Lakritzen Hans Riegel BetriebsgmbH and another v Finanzamt Linz* [2011] STC 917