The Personal Tax Planning Review

DEEMED DISPOSALS BY TRUSTEES: SEEING THE WOOD FOR THE TREES

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1 Scope and Purpose of Article

For United Kingdom capital gains tax purposes the trustees of a settlement are treated as a single and continuing body of persons who are thus capable of acquiring and disposing of assets and realising gains and losses in respect of such disposals.

There are a number of occasions when trustees are deemed to dispose of assets. Two of them have been introduced recently, by Finance Act 2000. I have discussed the complexities of the new provisions in my *Non-Resident Trusts* 8th edition, which was published by Key Haven this autumn, as well as in articles in *The Personal Tax Planning Review* and *The Offshore and International Taxation Review*. As the provisions are often complex, and it is often difficult to see the wood for the trees, in this article I point out for which events trustees should be on the look out to determine if they have made, or are about to make, a deemed disposal.

This scope of this article is confined to trusts which are resident only in the United Kingdom. Another version of the article, written primarily with non-UK resident and dual resident trusts in mind, is appearing in *The Offshore and International Taxation Review*.

2 Types of Deemed Disposal

There is a deemed disposal of settled property (or part thereof) in the following

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circumstances:

on the termination, on the death of the person entitled to it, of an interest in possession in all or any part of the settled property;

on property ceasing to be settled property by a beneficiary or the trustees of another settlement becoming absolutely entitled to it as against the trustees of the (first) settlement;

on the emigration of the trustees from the United Kingdom;

on the trustees, while remaining United Kingdom resident, becoming dual resident and entitled to double taxation convention protection from United Kingdom capital gains tax;

where the disposal of an interest under the settlement which brings into play Taxation of Chargeable Gains Act 1992 Schedule 4A; and

where there is a "transfer of value" by trustees "linked with trust borrowing" which brings into play Taxation of Chargeable Gains Act 1992 Schedule 4B.

3 Death of Person Entitled to Interest in Possession[2]

On the death of the person entitled to an interest in possession in all or any part of the settled property, the trustees are normally deemed to dispose of and immediately reacquire for a consideration equal to its market value the whole or corresponding part of each of the assets forming part of the settled property, but no chargeable gain is to accrue on the disposal. There are comparable rules which apply on the death of a person entitled to any annuity payable out of, or charged on, settled property or the income of settled property. There is an exception where hold-over relief has been claimed on a gift in settlement.

The result is thus normally beneficial. If the settled property has increased in value since the last acquisition (or deemed acquisition) by the trustees, there will be a tax-free uplift in the trustees' base cost. The deemed disposal will be disadvantageous insofar as the settled property comprises assets the sale of which

2 For further details, see my *Non-Resident Trusts* 8th edition 11.5.2.2.

would give rise to a loss. It would be advantageous for the trustees to realise any such assets, preferably by disposal to a non-connected person, before the death of the tenant for life.

It will normally be a simple matter to ascertain whether or not a person has died. It may be a more difficult matter if a beneficiary under the settlement has assigned his interest to another and the trustees do not have notice of the assignment or, in the case of an assignment to trustees, of the trusts on which the assigned interest is held.

4 Deemed Disposals on Termination of Settlement[3]

The general scheme of Taxation of Chargeable Gains Act 1992 is that whenever property ceases to be settled property, the trustees will be deemed to dispose of it and reacquire it at its market value as bare trustees for the person becoming absolutely entitled to it: Taxation of Chargeable Gains Act 1992 section 71(1).

A charge to capital gains tax on the trustees will in general be avoided, by section 73, provided that, if the property had not ceased to be settled property, there would have been a section 72 disposal. Where on the death of the beneficiary the property reverts to the "disponer", i.e. the settlor, the disposal and reacquisition are deemed to be for such consideration as to secure that neither a gain nor a loss accrues to the trustee.

When a person becomes absolutely entitled to any settled property as against a trustee, that property will normally cease to be "settled property" within the definition of Taxation of Chargeable Gains Act 1992 section 68. Even if the trustees continue to hold the legal title, subject to any lien they may have, they will hold the asset as bare trustee for the beneficiary who has become absolutely entitled and thus, by virtue of section 60, the Act is to apply as if the property were then vested in the beneficiary.

It will not normally be a problem for trustees to discover whether or not some person has become absolutely entitled to settled property.

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3 See further my *Non-Resident Trusts* 8th edition 11.5.3.

5 Emigration of Trustees from United Kingdom

Trustees who become neither resident nor ordinarily resident in the UK are normally deemed to dispose of the settled property and reacquire it at market value. This is a complex topic, discussed in my *Non-Resident Trusts* 8th edition Chapter 12.

6 Trustees Becoming Dual Resident in United Kingdom and Elsewhere

Trustees who are United Kingdom resident and who become dual resident are deemed to dispose of assets a gain on the disposal of which would be exempt from United Kingdom tax by virtue of a double taxation convention. See my *Non-Resident Trusts* 8th edition Chapter 12, especially at 12.6.2.3.

This is hardly likely to happen by accident.

7 Taxation of Chargeable Gains Act 1992 Schedule 4A Disposals

Taxation of Chargeable Gains Act 1992 Schedule 4A, which is headed "Disposal of interest in settled property: deemed disposal of underlying assets", operates by deeming the trustees of a settlement to make a disposal of the whole or part of the settled property for a market value consideration.

It comes into play only where the following conditions are met:

(a) there is a disposal of an interest in settled property for consideration *and*

(b) the following conditions are all satisfied

(i) the condition as to UK residence of the trustees

(ii) the condition as to UK residence of the settlor and

(iii) the condition as to settlor interest in the settlement.

The condition as to United Kingdom residence of trustees can, exceptionally, be satisfied even in the case of a trust which is not at any time resident or ordinarily

resident in the United Kingdom.[4]

The condition as to UK residence of the settlor is that:

> in the relevant year of assessment *or* in any of the previous five years of assessment,
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> a person who is a settlor in relation to the settlement either
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> (a) was resident in the United Kingdom during the whole or part of the year, or
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> (b) was ordinarily resident in the United Kingdom during the year.

Where the beginning of the disposal and its effective completion fall in different years of assessment, the condition is treated as met, however, if it is met in relation to either or both of those years of assessment or any intervening year.[5]

The condition as to settlor interest in the settlement is very complex. Broadly speaking, however, a "settlor-interested settlement" means a settlement in which a person who is a settlor in relation to the settlement "has an interest or had an interest at any time in the relevant period." The test of whether a settlor has an interest in a settlement is broadly the same as that which applies for the purposes of the capital gains tax Settlor Provisions which apply to United Kingdom resident trusts.[6]

Trustees may in some cases simply not know whether there has been an assignment of an interest such as to bring Schedule 4A into play.

8 "Transfer of Value" "Linked with Trust Borrowing"[7]

Taxation of Chargeable Gains Act 1992 Schedule 4B causes a disposal of settled

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4 See my *Non-Resident Trusts* 8th edition 12A.2.2.

5 See my *Non-Resident Trusts* 8th edition 12A.2.3.

6 See my *Non-Resident Trusts* 8th edition 12A.2.4.

7 See my *Non-Resident Trusts* 8th edition Chapter 12A.4 and 12A.5.

property for a deemed market value consideration. It applies only where there is a "transfer of value" by trustees which is "linked with trustee borrowing".

"Transfer of Value"

The trustees will make a transfer of value if they transfer money or any other asset to any person and receive a consideration whose amount or value is less than the market value of the asset transferred. If trustees transfer an asset (including cash) to any person otherwise than for a consideration whose amount or value is less than the market value of the asset, then they will obviously make a transfer of value. So too, if they issue a security and do not receive a consideration whose amount or value is equal to that of the security. In both these cases, there is a diminution in value in the trust fund.

Parodoxically, they will also make a transfer of value if they lend money or any other asset to any person and the value transferred is the market value of the asset. Thus, a commercial loan, such as a subscription for debentures in a quoted company, will potentially bring the provisions into play. By contrast, the acquisition for full consideration of a debenture already in issue will not. Particular care must be taken not only when loans are made to beneficiaries but also to companies wholly owned by the trustees. There are methods of achieving the equivalent of a borrowing without an actual borrowing.

"Trust Borrowing"

When a transfer of value is "linked with trust borrowing" is very complex. Much simpler is the question of whether there is any trustee borrowing. If there is not, then no transfer of value can be linked with any.

The trustees of a settlement "are treated as borrowing if –

(a) money or any other asset is lent to them, or

(b) an asset is transferred to them and in connection with the transfer the trustees assume a contractual obligation ... to ... transfer to any person ... any ... asset."

In the case of a simple loan to the trustees, there will inevitably be trust borrowing within the first head and the amount borrowed is the market value of the asset.

The second head will cover any situation where an asset is acquired by the trustees and they thereby become indebted to pay money, as where they buy on credit. It will thus include many transactions which are totally removed from the mischief at which the Schedule is aimed. For example the trustees contract to buy quoted shares, with settlement a few days ahead. Once the shares are transferred, there will be a loan, as the trustees will have assumed a contractual obligation to transfer to the vendor another asset, namely cash.

The "amount borrowed" in the case of a loan within the second head is "the market value of the asset reduced by the amount or value of any consideration received for it". Just as the second head is unbelievably wide, so the "amount borrowed" in relation to the second head is unbelievably narrow. Borrowings within the second head, which do not also fall within the first head, will therefore not usually present a problem.

The events which give rise to a Schedule 4B deemed disposal will normally be within the power and the knowledge of the trustees. The only circumstances in which they will not are where the trustees inadvertently make a bad bargain, whether on the sale or purchase of an asset or on the issuing of a security.

9 Conclusion

The number of deemed disposals has been substantially increased by Finance Act 2000. Trustees will need to be very careful that they do not inadvertently cause or allow one to occur. This will involve the trustees not only themselves acting with circumspection but keeping beneficiaries advised of how their actions can create a deemed disposal. That will not always be easy.

In some cases, deemed disposals will have occurred without the trustees being aware of the fact, even though they have exercised all due care. That will involve problems under the self-assessment system, partly for the trustees and/or their settlors or beneficiaries and partly for the Revenue.