The Personal Tax Planning Review

TEMPORARY NON-UK RESIDENTS AND TRUSTS

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1 Scope of Article

With effect from 17th March 1999, provisions were inserted into the UK capital gains tax legislation to charge to capital gains tax individuals who are "temporarily" non-UK resident. In particular, a new section 10A was inserted into the TCGA 1992. The scope of the article is to enquire what effect this has on the capital gains tax taxation of trustees, their settlors and beneficiaries. The section has no effect for income tax purposes.

2 Taxation of Trustees

2.1 The Potential Problem

For UK capital gains tax purposes, the trustees of a settlement[2] are regarded as a single and continuing body of persons (distinct from the persons who may from time to time be the trustees). That body is treated as being resident and ordinarily resident in the United Kingdom, and thus within the charge to capital gains tax, unless the general administration of the trust is ordinarily carried on outside the United Kingdom and the trustees or a majority of them for the time being are not

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2 This includes all but the simplest trusts: see Non Resident Trusts 8th edition at 11.2.

resident or ordinarily resident in the United Kingdom[3]. The residence of the trust will thus often depend on the residence status of the persons who happen to be the trustees.[4]

Suppose that there are two trustees of a settlement, neither of them resident or ordinarily resident in the United Kingdom. One of them becomes UK resident again after being "temporarily" non-UK resident. Does that affect the residence status of the trust in the intervening period? If so, given that, for a person to be more than "temporarily" non-UK resident, i.e. to escape section 10A, he must have been neither resident nor ordinarily resident in the UK for five full years of assessment[5], would it be unsafe or, at least, risky, to appoint as the trustee of a trust which it is desired to keep non-UK resident a person who has been resident or ordinarily resident in the UK in the current or any of the four immediately preceding years of assessment?

2.2 The Basic Law

Firstly, let us consider the law before section 10A complicated the position. Trustees are liable to capital gains tax on capital gains realised at any time in a year of assessment provided they are resident or ordinarily resident in the United Kingdom at some time in that year, whether or not at the same time as that at which they realise the gains in question. If, for example, there are two trustees of a settlement A and B, and A is at all material times neither resident nor ordinarily resident in the United Kingdom and B has not previously been resident or ordinarily resident in the United Kingdom but becomes resident on January 1st 2001, the trust will then be liable to tax on all capital gains realised during that year, whether before or after for the year 2000/2001, including gains realised before 2001.[6] Similarly, if B were to cease to be UK resident on 1st June 2001, the trust would still be liable to capital gains tax and gains realised at any time in the year to April 5th 2002.

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3 TCGA 1992 section 69(1). See my Non Resident Trusts 8th edition at 11.3.2.

4 In order not to deter foreign settlors from establishing their trusts in the UK, Taxation of Chargeable Gains Act 1992 section 69(2) deems certain trusts not to be either resident or ordinarily resident in the UK merely on account of their having a professional trustee or trustees who are resident here. See Non Resident Trusts 8th edition 11.3.2.2. In the rest of this article, I shall assume that section 69(2) does not apply.

5 I.e. a year ending on April 5th.

6 This is subject to any double taxation relief which may be available.

2.3 Dual resident trustees

It may be that the trustee of a settlement is himself dual resident in the United Kingdom and another state with which the UK has entered into a double taxation convention. It may further be that under the terms of that convention the individual is treated as a resident of the contracting state. This in itself, however, will have no effect on the residence status of the trust. The trustee is still a resident of the UK for municipal tax purposes: it is simply that, because he is a resident of the other contracting state for the purposes of the convention, he may be able to claim some personal relief from United Kingdom tax.

If the trust itself is dual resident, it may be able to claim relief from United Kingdom tax. That, however, is rather a different matter. Double taxation relief for trustees can be problematical, especially where the other Contracting State does not know how to treat trusts under its tax code. Moreover, there are some serious UK anti-avoidance provisions aimed at dual resident trusts.

2.4 Operation of Section 10A

The way section 10A works, where it bites, is to deem all chargeable gains and losses which, section 10A apart, would have accrued to the individual in one of the years of complete non-UK residence to be gains or losses accruing to him in the year of return. *Section 10A does not deem the individual to have been resident or ordinarily resident in the UK at any time when he was not.* Hence, section 10A of itself cannot affect the residence status of a settlement for capital gains tax purposes.

3 Taxation of Settlor and Beneficiaries

3.1 The Anti-Avoidance Provisions

The gains of non-UK resident trustees can be visited on settlors or on beneficiaries who receive "capital payments" from the trustees, under the Offshore Settlor Provisions and the Offshore Beneficiary Provisions respectively.[7] These provisions normally result in a charge to tax only where the settlor or beneficiary concerned is United Kingdom resident or ordinarily resident in the year of charge. Section 10A has extended the scope of that liability where the individual in question is temporarily non-UK resident.

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7 The extensive law is discussed in my Non Resident Trusts 8th edition Chapters 13 and 14 respectively.

3.2 Section 10A: the basic operation

As noted, the general scope of Taxation of Chargeable Gains Act 1992 section 10A is to charge to UK tax capital gains of individuals who cease to be resident or ordinarily resident in the United Kingdom for less than five years of assessment. It does so by deeming such gains to be gains of the year of return.

It is expressly stated that it applies to gains which would have been imputed to the taxpayer by Taxation of Chargeable Gains Act 1992 section 13 (gains of non-UK resident companies attributed to participators)[8] or section 86 (gains of non-UK resident trusts attributed to settlors). Taxation of Chargeable Gains Act 1992 Schedule 4C, added by Finance Act 2000, which deals with the attribution of gains which have been deemed to be realised by trustees on a Schedule 4B disposal, also contains specific provision for the case of the temporarily non-UK resident settlor.

What of gains imputed under Taxation of Chargeable Gains Act 1992 section 87 (gains imputed to beneficiaries and others who receive capital payments from the trustees)? These gains are in any case imputed irrespective of the residence status of the beneficiary. Hence, no special provision was needed.

There is an exemption in the case of assets acquired by the taxpayer in a year later than the year of departure. This cannot apply to assets which the taxpayer never owned, such as those of an offshore company or trust the gains on the disposal of which are imputed to him under Taxation of Chargeable Gains Act 1992 sections 13, 86 or 87.

To this exemption there are important exceptions, most notably the disposal of an interest "created by or arising under a settlement". This will often scupper devices such as a beneficiary becoming temporarily non-UK resident, the trustees conferring a fresh interest on him and his then selling it to an offshore bank. This exception can be circumvented by appropriate planning using a suitably worded double taxation convention.

3.3 Temporarily Non-UK Resident Settlors

3.3.1 The Problem

Section 10A operates on a "wait and see" basis. Where one is concerned with gains actually realised by an individual, this is feasible, as there is no particular difficulty

8 See my Non Resident Trusts 8th edition Chapter 15A.

in taxing them as gains of the year of return. The principal difficulty in the case of gains attributed to a settlor by the Offshore Settlor Provisions is the interaction with the Offshore Beneficiary Provisions. If gains are imputed to the settlor under the former, they are disregarded for the purposes of the latter. The Offshore Beneficiary Provisions operate on a year by year basis. It would be cumbersome, and a sacrifice of one of the advantages to be gained from self-assessment, if the calculation for one year in respect of a beneficiary could be reopened as much as four years later. For example, a settlor becomes non-UK resident on 1st April 1998. A section 87 calculation is made for 1998/99. It will be 6th April 2003 before one can be sure that the settlor has been more than "temporarily" non-UK resident.

3.3.2 The Solution

A new Taxation of Chargeable Gains Act 1992 section 86A deals with the problem of trust gains which would be imputed by section 86 to a settlor were he UK resident or ordinarily resident in a year of assessment. Although the wording is complex, the general idea is simple. In the years of non-UK residence of the settlor, one assumes that he will *not* be merely "temporarily" non-UK resident, so that all the trust gains for each year are taken into account for section 87 purposes. If and when the settlor returns so as to bring section 10A into play, one does not attribute to him any gain on which beneficiaries of the relevant settlement have been charged to tax under the Offshore Beneficiary Provisions. One does, however, attribute to him gains which have been imputed to beneficiaries who have not been charged to tax.

3.3.3 Calculation of the Attributed Gains

There is imputed to the settlor as gains of the year of his return only the "excess" mentioned in section 86A(1) and (2). Section 86A (attribution of gains to settlor in section 10A cases) provides:

> "(1) Subsection (2) below applies in the case of a person who is a settlor in relation to any settlement ('the relevant settlement') where—
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> (a) by virtue of section 10A, amounts falling within section 86(1)(e) for any intervening year or years would (apart from this section) be treated as accruing to the settlor in the year of return; and
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> (b) there is an excess of the relevant chargeable amounts for the non-residence period over the amount of the section 87 pool at the end of the year of departure.

(2) Only so much (if any) of:

(a) the amount falling within section 86(1)(e) for the intervening year, or

(b) if there is more than one intervening year, the aggregate of the amounts falling within section 86(1)(e) for those years,

as exceeds the amount of the excess mentioned in subsection (1)(b) above shall fall in accordance with section 10A to be attributed to the settlor for the year of return."

3.3.4 The Two Excesses

There are thus two excesses. The first is that mentioned in section 86A(1)(b). The second is that arrived at by deducting the first excess from the gains which would have been attributed to the settlor under section 86 had he remained UK resident throughout.

3.3.5 The First Excess

In order to determine the amount of the first excess, we need to consider two ingredients. The first is "the relevant chargeable amounts for the non-residence period". Section 86A(3) provides:

"(3) In subsection (1) above, the reference to the relevant chargeable amounts for the non-residence period is (subject to subsection (5) below) a reference to the aggregate of the amounts on which beneficiaries of the relevant settlement are charged to tax under sections 87 or 89(2)[9] for the intervening year or years in respect of any capital payments received by them."

What of a person who is not a beneficiary of a settlement but is deemed to be such? Section 97(8) deems such a person to be a beneficiary for the purposes of section 87 and most of the Offshore Beneficiary Provisions. Section 97(8) now applies for the interpretation of section 86A too, so that whenever there is a charge under section 87 there will be relief under section 86A.

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9 Which operates in a similar way to section 87 and deals with the case where a UK resident settlement has "stockpiled" section 87 trust gains realised in a "non-resident" period, i.e. gains which have not as yet been imputed to beneficiaries. See my Non-Resident Trusts 8th edition 14.3.2.

A more difficult question is when exactly a beneficiary is "charged to tax" under sections 87 or 89(2). Section 87 is not a charging section. It merely imputes a gain to a person. If that person is not resident or ordinarily resident in the United Kingdom in the year in question, then he will normally be outside the charge to tax in respect of that gain. It is in my view clear that such a beneficiary would not be "charged to tax" in respect of a trust gain imputed to him under the Offshore Beneficiary Provisions. Other cases are less clear. A person who is in principle liable to tax might not in fact pay tax because the gain was covered by his annual exemption.[10] Then again, it might be a charitable corporation which could, subject to certain conditions, claim relief from tax.[11] It is arguable that in both cases the beneficiary has been "charged to tax" in respect of the gain in the sense that the gain has entered into a computation of his liability. Although this is not the normal meaning of the words, there is a strong argument that this should be their interpretation, on a purposive construction. The gain has in fact been imputed to someone who was potentially taxable on it. If that person did not, because of his personal circumstances, pay tax on it, that is no reason why the settlor should. One can point to anomalous situations. If, say, the imputed gain is £7,201 in 1998/99 and the beneficiary has no other gains in the year, he will be charged to tax in respect of the gain whereas if the imputed gain is £7,199 he will not.[12] On the contrary view, the charge to tax on £1 would take £7,201 of gains out of section 86A.

Section 86A(3) is expressly subject to section 86A(5), which merely provides, in an equitable way, for apportionment of gains in the case of settlements with multiple settlors. It provides:

> "(5) Where the property comprised in the relevant settlement has at any time included property not originating from the settlor, only so much (if any) of any capital payment or amount carried forward in accordance with section 87(2) as, on a just and reasonable apportionment, is properly referable to property originating from the settlor shall be taken into account

10 No difficulty arises as regards allowable losses of the beneficiary, given that, as from 1998/99, he can no longer set off personal losses against gains imputed under the Offshore Beneficiary Provisions: Finance Act 1998 Schedule 21 paragraph 2, inserting in the Taxation of Chargeable Gains Tax Act section 2(4) and (5). See also my Non-Resident Trusts 8th edition at 11.6.4.7.

11 See my article *Charities and Imputed Capital Gains* in *Charities Law and Practice Review* Volume 5, Issue 3, at p. 235.

12 An individual's annual exemption in this year is in respect of the first £7,200 of chargeable gains, reduced by any taper relief.

for the purposes of subsections (3) and (4) above."

In order to calculate the first excess, one also needs to know what is meant by "the section 87 pool at the end of the year of departure". Section 86A(4) provides:

> "(4) In subsection (1) above, the reference to the section 87 pool at the end of the year of departure is (subject to subsection (5) below) a reference to the amount (if any) which, in accordance with subsection (2) of that section, fell in relation to the relevant settlement to be carried forward from the year of departure to be included in the amount of the trust gains for the year of assessment immediately following the year of departure."[13]

In other words, one attributes gains on which beneficiaries "charged to tax" on a FIFO basis, year by year. Before there can be any relief under section 86A for the settlor who returns from his temporary non-UK residence, the pool of trust gains for the year of departure must first be exhausted by being attributed to beneficiaries "charged to tax".

3.3.6 The Second Excess

We are now in a position to calculate the second excess. It is the excess of the section 86 gains for the years of complete non-UK residence, minus gains attributed in the years to beneficiaries "charged to tax" in those years, plus trust gains outstanding capable of being imputed to beneficiaries at the end of the year of departure. It is that excess which is imputed to the settlor in the year of return.

3.3.7 Double Taxation Conventions

It might be asked whether a settlor could claim relief from tax on gains attributed under section 86A on the basis of a double taxation convention, which would normally be between the UK and his country of residence during his absence from the UK. While in principle he can, everything may depend on the wording of the convention in question. In any event, he is likely to meet with resistance from the Revenue. The standard terminology is: "Gains from the alienation of any property other than that referred to [above] shall be taxable only in the Contracting State of which the alienator is a resident."[14] The Revenue are likely to argue, citing the

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13 As to section 86A(5), see above.

14 See OECD Model Treaty article 13(4).

analogy of *Bricom Holdings Ltd v IRC*,[15] which was decided on the controlled foreign companies provisions, either that the settlor is not an "alienator" or that the only "alienators" are the trustees of the settlement.[16]

3.4 Temporarily Non-UK Resident Beneficiaries

As noted, Taxation of Chargeable Gains Act 1992 section 87 imputes capital gains to beneficiaries who receive capital payments from trustees. The imputation is irrespective of the beneficiary's residence status. The beneficiary can be chargeable to tax, however, only if the gain is imputed to him in a year in which he is resident or ordinarily resident in the United Kingdom. Thus, in principle, section 87 interacts smoothly with section 10A. A gain prima facie imputed in a year of mere temporary non-UK residence will be imputed to the beneficiary in the year of his return.

The only complication arises from the interaction with the Offshore Settlor Provisions contained in Taxation of Chargeable Gains Act 1992 section 86. That has been discussed at 3.3.

3.5 Anti "Flip Flop" Provisions[17]

Prior to the 2000 Budget Speech, a capital gains tax avoidance scheme known as a "flip flop" was sometimes practised. The aim was to side-step one or more of the United Kingdom Settlor Provisions, the Offshore Settlor Provisions or the Offshore Beneficiary Provisions. The trust could be resident in or out of the United Kingdom. The Trustees would typically borrow funds in one year of assessment and appoint them so that they were no longer property comprised in the same settlement. There might then be a reorganisation of beneficial interests. In the next year of assessment, capital gains would be realised by the trustees and the borrowing repaid.

There were several versions of the scheme. If the purpose was simply to avoid the United Kingdom Settlor Provisions or the Offshore Settlor Provisions, then, after the appointment in Year 1, the trusts would be modified so as to ensure that the relevant

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15 [1997] STC 1179.

16 See my articles in *The Offshore Taxation Review* in Volume 6, Issue 3, at page 151 'Double Taxation Treaties: the Antidote to Anti-Avoidance Provisions? (on the Special Commissioner's decision)' and, in Volume 7, Issue 3, at p.151, *Bricom Holdings Ltd v IRC Treaty Override: Bricom Holdings Ltd v IRC in the Court of Appeal.*

17 These provisions are discussed in my Non-Resident Trusts 8th edition Chapter 12A.

Provisions did not apply to the trust for the next year of assessment. If the aim was to avoid the Offshore Beneficiary Provisions, the appointment would be to another trust. In calculating the section 87 gains which could be transferred to that trust, one would not take into account any gains realised in a subsequent year of assessment.[18] Hence, beneficiaries could receive capital payments from that trust in due course without any section 87 liability. In principle, it was possible to appoint out virtually the whole of the value of the trust fund without any beneficiary, including the settlor or his spouse, being charged to capital gains tax on gains realised by the trustees only in a later year of assessment.

An attempt has been made to counter the use of such schemes by the addition of new Schedules 4B and 4C to the Taxation of Chargeable Gains Act 1992. The effect of Schedule 4B is to deem trustees, in certain circumstances where they make a "transfer of value" which is "linked with trust borrowing", to dispose of and reacquire settled property for a market value consideration. Schedule 4C can come into play only where Schedule 4B has operated. It ring-fences any section 87 trust gains which non-UK resident trustees realise as a result of a Schedule 4B deemed disposal and lays down different rules for determining to which beneficiaries they are to be attributed under the Offshore Beneficiary Provisions.

Schedule 4C, too, needs special rules to deal with temporarily non-UK resident settlors. These rules by and large mirror the rules for the Offshore Settlor Provisions, discussed at 3.3. Schedule 4C paragraph 12 applies where:

> "by virtue of section 10A an amount of gains –
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> (a) arising under Schedule 4B in an intervening year, and
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> (b) falling within section 86(e),
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> would (apart from this Schedule) be treated as accruing to a person ("the settlor") in the year of return."

18 For the transfer of section 87 trust gains from one settlement to another see my Non-Resident Trusts 8th edition 14.11.2.

Where the paragraph applies:

> "only so much (if any) of the Schedule 4B trust gains falling within section 86(1)(e) as exceeds the amount charged to beneficiaries shall fall in accordance with section 10A to be attributed to the settlor for the year of return."

4 Conclusion

The rules for temporarily non-UK residents do not as such affect the residence status of settlements. They do make life more difficult for temporarily non-UK resident settlors and beneficiaries. Much can be done, however, if the taxpayer becomes a resident of a state with a double taxation convention with the United Kingdom couched in suitable terms. Fortunately, the United Kingdom has entered into such conventions with many developed countries.