

PRE 1991 NON RESIDENT TRUSTS TREATMENT OF NET LOSSES INCURRED IN THE 1998-99 TRANSITIONAL PERIOD

Sarah Dunn¹

1 Introduction

The Finance Act 1998 made several changes to the anti-avoidance provisions that tax the gains of certain non resident trusts. The trustees are outside the scope of UK tax, but the provisions impose a charge on settlors or beneficiaries who have a sufficient connection with the UK. Until 1998, the settlor charge did not apply to trusts created before 19th March 1991 – and these became known as golden trusts – provided that they remained untainted.

The Finance Act 1998 ended this special treatment, but the changes were not fully effective until 6th April 1999. It was not until that date that a former golden trust became a *qualifying settlement*. Being a qualifying settlement is a condition of the application of the charge and is one which such a trust would not previously have satisfied. Before 6th April 1999, the trust could be terminated; taken outside the scope of the charge by another route (such as by excluding all defined persons from benefiting); or become a protected settlement. In any of those cases, any gains realized between 17th March 1998 and the relevant event would escape the settlor charge. If none of these things happened, and the trust came within the scope of the charge on 6th April 1999, then special transitional provisions sought to tax gains and losses realized in the transitional period. The purpose of this article is to highlight the Revenue's interpretation of these provisions when applied to a net loss realized in the transitional period; and to explain why this approach is anomalous and not

¹ Sarah Dunn, Barrister, Pump Court Tax Chambers, 16 Bedford Row, London WC1R 4EB.
Tel: (020) 7414 8080; Fax: (020) 7414 8099.

correct.

2 Background

The relevant taxing provision is section 86 TCGA 1992. If certain conditions are satisfied in a year of assessment, then the trustees' net gains in that year are attributed to the settlor. The conditions are:

- (i) that the settlement is a qualifying settlement in that year;
- (ii) that the trustees are neither resident nor ordinarily resident at any time in the year (or so treated by virtue of double taxation relief arrangements);
- (iii) that the settlor is domiciled in the UK at some time in the year and is either resident during any part of the year or ordinarily resident during the year;
- (iv) that the settlor has an interest in the settlement at any time during the year; and
- (v) that paragraphs 3, 4 and 5 of Schedule 5 do not apply.

The following example describes a simple non resident trust which clearly satisfies conditions (ii) to (v) – and has done since its creation – but which, until the 1998 changes, was not a qualifying settlement and so did not satisfy condition (i): -

Example

- On 3rd July 1985, Tom Golden settled some shares and cash on a discretionary trust ("the Golden Trust").
- The beneficiaries are Tom, his wife, his children and remoter issue.
- The trustees were resident in Guernsey at all material times.
- Tom Golden has always been domiciled, resident and ordinarily resident in the UK.
- No property was added to the trust after its creation.

- There have been no changes to the terms of the trust or its beneficiaries since its creation.

Before 1998, a trust created *on or after* 19th March 1991 was a qualifying settlement in the year in which it was created and all subsequent years of assessment.² However, those created *before* 19th March 1991 were not qualifying settlements at all unless they became tainted³ after that date by the addition of further property, by the trustees becoming non resident for the first time or by certain persons actually or potentially enjoying a benefit for the first time. In the example given, the trust was created before 19th March 1991 and has not been tainted since. Thus it was not a qualifying settlement before 1998.

3 The 1998 Changes

Paragraph 9 of Schedule 5 to TCGA 1992 defines a qualifying settlement. The definition is divided into two parts. The first part, which applies to settlements created on or after 19th March 1991, is simple. They are qualifying settlements in the year of assessment in which they are created and all subsequent years of assessment.

The second part, applicable to settlements created before 19th March 1991, is slightly more complicated. Before 1998, they were not qualifying settlements at all unless and until they were tainted. The Finance Act 1998 amended this part of the definition and it is now as follows:

- (1A) Subject to sub-paragraph (1B) below, a settlement created before 19th March 1991 is a qualifying settlement for the purposes of section 86 and this Schedule in –
- (a) the year 1999-00, and
 - (b) subsequent years of assessment.
- (1B) Where a settlement created before 19th March 1991 is a protected settlement immediately after the beginning of 6th April 1999, that settlement shall be treated as a qualifying settlement for the

² Paragraph 9(1) of Schedule 5 to TCGA 1992 *before* FA 1998 amendments.

³ Paragraph 9(2).

purposes of section 86 and this Schedule in a year of assessment mentioned in sub-paragraph (1A) (a) or (b) above only if –

- (a) any of the five conditions set out in subsections (3) to (6A) below becomes fulfilled as regards the settlement in that year; or
- (b) any of those five conditions became so fulfilled in any previous year of assessment ending after 19th March 1991.

In summary, a golden trust will be a qualifying settlement from 1999-00 onwards unless it was a protected settlement on 6th April 1999. Even a protected settlement will be a qualifying settlement in 1999-00 if it had been tainted previously or if it becomes tainted in that year. It will also become a qualifying settlement in a future year of assessment in which it is tainted. Tainting comprises the same things as before, with the addition of ceasing to be a protected settlement after 6th April 1991.

The transitional period (17th March 1998 to 5th April 1999) enabled those involved with golden trusts to avoid falling within the scope of section 86 TCGA 1992. The trust could be brought onshore; brought to an end; or all defined persons could be excluded from benefiting. Defined persons are the settlor, his spouse, their children and grandchildren, those children's or grandchildren's spouses and companies controlled by any of the above or associated with such a company.

If all such persons were excluded, the settlor would not have an interest in the settlement and condition (iv) above would not be satisfied. Thus, qualifying settlement or not, section 86 would not apply. However, it is often not possible to exclude minor, unborn and unascertained beneficiaries and it is probably for this reason that the concept of a protected settlement was introduced. If the only defined persons who can benefit are minor or unborn children of the settlor, or future (i.e. unascertained) spouses of the settlor and various others, then the settlement is protected from section 86 by being excluded from the definition of a qualifying settlement. Thus condition (i) will not be satisfied.

As long as a golden trust removed itself from the scope of section 86 TCGA 1992 by 6th April 1999, its gains since budget day escaped tax under section 86. However, for those that would become qualifying settlements and chargeable under section 86 on 6th April 1999, the net extended back to 17th March 1998. Otherwise, once on notice, many trustees would doubtless have realized all their

latent gains during this period in order to acquire a higher base cost for the future⁴. This was prevented by the transitional provisions in Schedule 23 to FA 1998.

4 The Transitional Provisions

The relevant transitional provisions are those in paragraph 1 of Schedule 23 to FA 1998. They apply to a settlement if:

- (a) it was created before 19th March 1991;
- (b) it was *not* a qualifying settlement in 1998-99;
- (c) it *was* a qualifying settlement in 1999-00; and
- (d) it was *not* a protected settlement immediately after the beginning of 6th April 1999.

If all of the above apply, then gains or losses accruing on or after 17th March 1998 and before 6th April 1999 are treated as accruing on 6th April 1999, provided that they accrue in a year throughout which the trustees are non resident.

This method of taxing transitional gains was probably chosen on the grounds of simplicity. It would have taken more complicated drafting to have achieved the desired result through the concept of qualifying settlements. It would not have been simply a matter of distinguishing between those settlements that became qualifying on 17th March 1998 and those that did not. First, 17th March 1998 was not the beginning of a year of assessment and whether a settlement is or is not a qualifying one is otherwise determined for a year of assessment as a whole. Secondly, the question would have had to be answered retrospectively: the tax position for at least part of 1997-98 would have depended on the settlement's status in 1999-00. These problems would certainly not have been insurmountable, but they illustrate the

⁴ In a case where the settlor is excluded from benefit and the beneficiaries are all potentially within the charge under section 87, one might query whether it would have been consistent with the trustees' fiduciary duties to have done this. Particularly in the case of trustees resident in a jurisdiction which would not enforce the settlor's right of indemnity, it would be in the (financial) interests of the beneficiaries to maximize the gains taxable under section 86 where this would minimize the pool of trust gains for the purposes of section 87. The contrary view is that it would not be in the wider interests of the beneficiaries to penalize the settlor in this way. The extent to which those wider interests are relevant may vary according to the law governing the trusts. The question is academic in the present context, but the essential issue is one which frequently arises in the context of section 86 and Schedule 5 TCGA 1992.

relative simplicity of the method chosen – that of deeming transitional gains to accrue on 6th April 1999 in appropriate cases.

Let us return to the Golden Trust in the example at 2 above. Suppose that the Guernsey trustees made the following disposals: -

- (x) A disposal of 100 shares in X plc on 10th June 1998, realizing a gain of £200.
- (y) A disposal of 100 shares in Y plc on 1st March 1999, realizing a loss of £100.
- (z) A disposal of 100 shares in Z plc on 30th April 1999, realizing a gain of £300.

The first two disposals occurred within the transitional period.

The Golden Trust was created before 19th March 1991. Because of this, and because it was never tainted, it was not a qualifying settlement in 1998-99. However, it became a qualifying settlement in 1999-00: it was not a protected settlement immediately after 6th April 1999. Thus all four of the conditions set out at (a) to (d) above are satisfied and the transitional provisions apply. This means that any gains and losses that accrued to the trustees in the transitional period are deemed to have accrued on 6th April 1999. The first two disposals mentioned above occurred in the transitional period. The gain of £200 on the shares in X and the loss of £100 on the shares in Y will be treated as accruing, in the year of assessment 1999-00.

Assume that the disposal on 30th April 1999 of shares in Z plc was the only actual disposal in the year 1999-00. The result will be that the trustees have net gains for 1999-00 of £400 (£300 + £200 - £100). These will be attributed to Tom under section 86 and he will be taxed according to his personal circumstances.

5 The Revenue's View

So far, the interpretation of the legislation has not been controversial. Let us change the facts a little. Suppose that the shares in X were not sold on 10th June 1998. This would mean that there was only one disposal in the transitional period: the disposal of the shares in Y, which generated a loss of £100. One might think that that loss would be deemed to accrue on 6th April 1999 and that – once set off against the £300 gain on the shares in Z – there would be net gains for 1999-00 of £200.

Apparently the Revenue does not share this view. I understand that it has recently argued that, if there is a net loss on disposals made during the transitional period, then that loss is not deemed to accrue on 6th April 1999 and is not available for set off against gains actually realized in 1999-00. The applicable wording in paragraph 1(2) of Schedule 23 of FA 1998 is: -

..... section 86 shall have effect as if any relevant⁵ gains or relevant losses accruing to the trustees of the settlement on or after 17th March 1998 and before 6th April 1999 were gains or losses accruing to those trustees on 6th April 1999

It is certainly not clear from that provision why losses should be treated differently from gains nor, why a particular loss incurred in the transitional period should be treated differently according to whether there are net gains or net losses in that period. The wording of paragraph 1(2), cited above, does not indicate that it is the net figure which is deemed to accrue on 6th April 1999. It appears to be each individual gain and loss which is deemed to accrue then. Even if one could read in words so as to require the gains and losses to be netted off first, there is still nothing to suggest that a net loss is treated differently from a net gain.

The basis of the Revenue's argument is apparently section 132 of FA 1998. The relevant subsections are (5) and (6):

(5) In construing section 86(1)(e) of the Taxation of Chargeable Gains Act 1992 (which specifies the amount by reference to which a charge arises under that section) as regards a particular year of assessment and in relation to a settlement created before 19th March 1991 which -

- (a) is a qualifying settlement in the year 1999-00, but
- (b) was not a qualifying settlement in any earlier year of assessment,

no account shall be taken of disposals made before 6th April 1999 (whether for the purpose of arriving at gains or for the purpose of arriving at losses).

⁵ Gains or losses are "relevant" in this context if they accrued in a year throughout which the trustees were neither resident nor ordinarily resident - or were deemed not to be under double taxation relief arrangements. See paragraph 1(4) of Schedule 23 of FA 1998.

- (6) Schedule 23 (which makes transitional provisions in connection with the coming into force of this section) shall have effect.

The Revenue argues that losses which accrued during the transitional period are not taken into account because they accrued on disposals made before 6th April 1999. Section 132(5) FA 1998 states that, in construing section 86(1)(e) TCGA 1992, those disposals are to be left out of account.

6 The Contrary View

Section 132(5) FA 1998 itself is clear. Disposals made before 6th April 1999 are to be left out of account. The real question is whether disposals made in the transitional period, and which fall within paragraph 1 of Schedule 23, are indeed disposals made before 6th April 1999 for this purpose. Plainly they are in fact made before 6th April 1999. But Schedule 23 deems them to have accrued *on* 6th April 1999 for the purposes of section 86. The question is: does this take them outside the terms of section 132(5)? Or, put another way, does the scope of the deeming provision extend to section 132(5)?

There are two principal reasons why the answer must be yes:-

- (1) Paragraph 1 of Schedule 23 requires section 86 to have effect as if certain gains or losses had accrued on 6th April 1999. A provision – such as section 132 – that deals with the construction of section 86 itself must *prima facie* be within the scope of this deeming provision.
- (2) The alternative would make the transitional provisions completely ineffective. Neither section 132 nor paragraph 1 of Schedule 23 distinguishes between gains and losses. Nor do they distinguish between a net gain position and a net loss position. Thus, if the Revenue were right, all transitional gains and losses of golden trusts that first become qualifying settlements on 6th April 1999 would be left out of account. This would clearly contravene the legislative purpose and would make the whole Schedule redundant.

I have said that the legislation does not justify drawing a distinction between net gains realized in the transitional period and net losses. This is the point on which my views differ from those of the Revenue. If the Golden Trust had made the three disposals described at 4 above, the Revenue would have allowed the loss on the Y shares (£100) to be set off against the gain on the X shares (£200), leaving a net gain

of £100 to be carried forward to 6th April 1999 and aggregated with the gains on the Z shares. Thus the Revenue seems to accept that the deeming effect of paragraph 1 of Schedule 23 *does* extend to section 132 in relation to both gains and losses, at least where the losses do not exceed the gains. What the Revenue would not permit is for the loss on the Y shares alone to be carried forward and set off against the gains on the Z shares if there had been no disposal of the Z shares and no transitional gain.

How this distinction is arrived at I am not sure. It would seem to involve reading words into paragraph 1 of Schedule 23 along the lines of "*provided that this paragraph shall not apply to relevant losses to the extent that they exceed relevant gains*". There is no justification for reading in those words. The paragraph refers to *any* relevant gains or relevant losses and there is no reason to suppose that this was not the legislative intent. If I am right that this is not a justifiable distinction to draw, then an isolated transitional loss must be treated as arising on 6th April 1999 unless no transitional gains or losses are so treated. I would reject the latter argument for reasons (1) and (2) set out above.

7 Conclusions

If the conditions of paragraph 1 of Schedule 23 to FA 1998 are met, then gains or losses or both that accrued in the transitional period are deemed to accrue on 6th April 1999 for the purposes of section 86 TCGA 1992. This is not overridden by section 132 FA 1998, even where there are net losses in the transitional period. Any argument to the contrary should be firmly resisted.