TRUSTEE INVESTMENT IN OFFSHORE FUNDS

Robert Venables[1]

1 The Background

The United Kingdom Offshore Funds anti-avoidance legislation is aimed at investment in offshore "collective investment schemes",[2] in particular, "roll-up" funds, which do not distribute income or gains. The actual fund can be owned by an offshore company, in which case the investor buys shares. Alternatively, it can be held by the trustees of a unit trust, in which case the investor buys units, provided that the trust is not fiscally transparent. So long as there are no distributions, the investor neither receives taxable income nor realises chargeable gains. When he ultimately disposes of his interest, any gain he makes would prima facie be a chargeable one, liable only to capital gains tax.

The Offshore Funds Provisions ("the Provisions"), now contained in Taxes Act 1988 Part XVIII Chapter V, sections 757-764, operate by treating the capital gain which is realised as an income gain. There is no indexation relief or taper relief. At the time when the Provisions were introduced, this made sense, as the maximum rate of tax on investment income was two and a half times that on capital gains. Nowadays, the Provisions make rather less sense.

It was formerly debatable whether, in an appropriate case, the Revenue could tax an individual investor ordinarily resident in the United Kingdom on "his" portion of the income of the underlying fund. The very enactment of the Provisions has made that very difficult indeed for the Revenue, given the decision of the House of Lords in

---

1 Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UP.
Tel: (0171) 242 2744 Fax: (0171) 831 8095.
Consulting Editor.

2 As defined by Financial Services Act 1986.

IRC v Willoughby.[3]

2 Scope of the Article

In this article, I suggest:

(a) investment in offshore funds can be tax-efficient for non-United Kingdom resident trusts where it is expected that beneficiaries domiciled and resident or ordinarily resident in the United Kingdom will receive capital payments from the trustees, and

(b) the holding of interests in material funds in an interest in possession trust, no matter where resident, may possible prevent the Provisions applying.

3 Non-UK Resident Trusts

3.1 Gains realised by Trustees

If non-UK resident trustees dispose of a material interest in a non-qualifying offshore fund, then the capital gain is deemed to be notional income. While the trustees themselves will not, by virtue of their non-UK residence, be liable to income tax on this notional income,[4] it can be treated as income payable to them for the purposes of the income tax transfers of assets abroad anti-avoidance provisions.[5] It can also be taken into account so as to impute notional income to a beneficiary under the Offshore Beneficiary Provisions as applied, with adaptations, for this purpose.[6]

3.2 Gains of Offshore Companies owned by Trustees

If such a gain arises to an offshore company owned by the trustees, the notional income of that company can be taken into account both for the purposes of the

---

3 (1997) 70 TC 57; [1997] STC 995

4 If they were United Kingdom resident, the deemed income would be chargeable at the rate applicable to trusts, in just the same way as accumulated income: section 764.

5 Contained in Taxes Act 1988 Part XVII Chapter III: see section 762(5).

6 See section 762(5) and section 762(2)-(4). For the Offshore Beneficiary Provisions see my *Non-Resident Trusts* 7th edition Chapter 14.

income tax transfer of assets anti-avoidance provisions[7] and for the purposes of the Offshore Beneficiary Provisions as applied for the purposes of the Offshore Funds legislation, in much the same way as if it were a normal capital gain,[8] but subject to one important exception.

3.3 Double Taxation: Transfers of Assets Abroad Provisions

Prima facie, an offshore income gain of non-United Kingdom resident trustees or companies can be taken into account for *both* the purposes of the income tax transfers of assets abroad anti-avoidance provisions *and* the adapted Offshore Beneficiary Provisions. The only exception is that the gain cannot be deemed to be income of any individual for the purposes of Taxes Act 1988 section 739 or section 740 if, by virtue of the capital gains tax provisions, it is treated as having accrued to any person resident or ordinarily resident in the UK.[9] The result is that, unlike in the case of normal capital gains, it is not as a matter of strict law possible to "wash" a gain by appointing capital to a person not resident or ordinarily resident in the UK.[10]

If section 739 or section 740 operates so as to tax a UK ordinarily resident individual on an amount equal to that of the offshore income gain realised by the trustees, there appears to be nothing to prevent the same gain being also taken into account under the Offshore Beneficiary Provisions. This is probably an oversight on the part of the draftsman and one would not expect the Revenue to seek to charge twice over.

If the settlor and any spouse of his are excluded from benefit, then section 739 cannot normally apply. Likewise, it cannot apply if the settlor is dead. Section 739 may not apply because the motive defence is available. In that case, although the income tax settlement provisions, contained in Taxes Act 1988 Part XV would, if the settlor or his spouse retained any interest under the settlement, normally apply so as to deem income arising under the settlement to be that of the settlor for income tax purposes, it is arguably that section 763 impliedly excludes such a result.

If section 739 does not apply, section 740 can in principle apply. Yet section 740

---

7 See section 762(5), which applies to any person resident or domiciled outside the United Kingdom.

8 Taxation of Chargeable Gains Act 1992 section 13(10).

9 See Taxes Act 1988 section 762(6).

10 See my *Non-Resident Trusts* 7th edition 10.3.2, 14.14, 14.15 and 14.16.

may itself not apply for a variety of reasons. Possibly, the motive defence, contained in section 741, will be available. This will often be the case where the settlor was not United Kingdom domiciled or resident when he made the settlement.

3.4 No Surcharge

If section 740 applies, then a capital payment received by a beneficiary ordinarily resident in the United Kingdom at a material time may be taxable as income. There will, however, be no surcharge. In the case of a capital gain imputed under the Offshore Beneficiary Provisions, the surcharge can increase the tax charge from 40% to up to 64%.

Where the Offshore Beneficiary Provisions apply so as to visit an offshore income gain on a beneficiary, there is no surcharge either. This is a very considerable advantage of an offshore fund gain. Moreover, the legislation helpfully provides that a capital payment is deemed to be an offshore income gain before it is deemed to be a capital gain.[11]

Care must be taken if a capital payment is made to a person who is neither resident nor ordinarily resident in the United Kingdom and further payments are contemplated to persons who are ordinarily resident in the United Kingdom .[12]

4 Interest in Possession Trusts

Where trustees do hold a material interest in an offshore income fund, there will normally be very little scope for tax planning. It has been suggested that one possibility is to create an interest in possession in the interest so that the gain will be washed on the death of the beneficiary. This is based on the view that, while there is no tax-free uplift in a material interest in a non-qualifying offshore fund on the death of a person absolutely entitled, there is such an uplift on the death of a tenant for life under a trust, whether or not UK resident.[13]

The normal rule is that there is a disposal for the purposes of the offshore funds

---

11 Section 762(4).

12 See further my *Non-Resident Trusts* 7th edition 10.7.3.3.

13 Inheritance tax considerations would also have to be borne in mind.

legislation whenever there is a disposal for capital gains tax purposes.[14] There is, for capital gains tax purposes, no disposal on the death of a person of assets to which he was absolutely entitled: Taxation of Chargeable Gains Act 1992 section 62(1)(b). That rule is expressly reversed for the purposes of the offshore funds legislation by Taxes Act 1988 section 657(3).

In the case of assets held by the trustees of a trust in which there subsists a life interest in possession, there is on the death of the tenant for life for capital gains tax purposes a deemed disposal and reacquisition by the trustees of the trust assets, but no chargeable gain accrues on the disposal.[15] There is no express provision in the offshore funds legislation which deems there to be a disposal for the purposes of that legislation. Hence, it might be thought that there is no charge under the legislation in such a case, but there is a tax-free uplift in base cost.

The difficulty with this argument is that the relevant sections of the Taxation of Chargeable Gains Act 1992 expressly say that there is a deemed disposal. They then go on to say that "no chargeable gain shall accrue on" the "disposal". The charge to income tax under the offshore funds legislation is contained in Taxes Act 1988 section 761(1), which provides:

> "If a disposal to which this Chapter applies gives rise in accordance with section 758 or Schedule 28 to an offshore income gain, then, subject to the provisions of this section, the amount of that gain shall be treated for all the purposes of the Tax Acts as ... income ..."

Taxes Act 1988 Schedule 28 paragraph 5 provides that, subject to an immaterial exception, a material disposal gives rise to an offshore income gain of an amount equal to the "unindexed gain" on that disposal. Subject to immaterial exceptions, the "unindexed gain" accruing on a material disposal is the amount which would be "the gain" on that disposal for the purposes of the Taxation of Chargeable Gains Act 1992 if it were computed on certain immaterial hypotheses: see paragraph 2(2).

Now, on the death of a tenant for life under a trust, the trustees are deemed to dispose of the trust assets but no "chargeable gain" is to accrue on the disposal. Is it possible for the Revenue to argue that there is a "gain" for the purposes of the Taxation of Chargeable Gains Act 1992 even though it is not a "chargeable gain"? Prima facie, it is, as the two concepts are different. Taxation of Chargeable Gains

---

14 Taxes Act 1988 section 757(2).

15 See Taxation of Chargeable Gains Act 1992 section 72(1) in the case where the trust assets continue to be settled property, and section 71 and section 73(1) where they do not.

Act 1992 section 15(2) provides that every gain shall, except as otherwise expressly provided, be a chargeable gain. Section 223(1), for example, provides that no gain to which section 222 (relief on disposal of private residence) applies shall be a chargeable gain.

Against this, one can argue that as paragraph 2(2) refers to "the gain .. for the purposes of the [1992] Act if it were computed ...", "the gain" must refer to "the chargeable gain", as it is never necessary to compute for the purposes of the 1992 Act a gain which is not a chargeable gain.

Then again paragraph 3(1) provides "If the amount of any *chargeable gain*[16] ... which ... would accrue on the material disposal would fall to be determined in a way which ... would take account of the indexation allowance on an earlier disposal ... [which was a disposal on a no gain/no loss basis] ..., the unindexed gain on the material disposal shall be computed as if ... no indexation allowance had been available on any such earlier disposal ..." This, it could be argued, presupposes that "the gain" in paragraph 2(2) means "the chargeable gain".

In summary, it is by no means clear whether offshore income gains of trustees are washed on the death of the tenant for life. Trustees may, however, consider that there is nothing to be lost in following this strategy, if otherwise they or their beneficiaries would pay tax in any event.

5 Conclusion

Material interests in non-qualifying offshore funds may well be tax-efficient investments for non-UK resident trustees where it is expected that beneficiaries who are United Kingdom resident and domiciled at a material time will receive capital payments from the trustees. When the Provisions were introduced, it was normally to the advantage of the Revenue that the gain should be taxed as income. Now that there is a surcharge on distributions from non-UK resident trusts which are taxable under the Offshore Beneficiary Provisions, it is normally to the advantage of the taxpayer.

16 Italics supplied.