

SECTION 77 TCGA AND THE NON-DOMICILED SETTLOR

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- 1.1 The last edition of the OITPR contained an article by Robert Venables relating to several aspects of sections 77 and 86 of the Taxation of Chargeable Gains Act 1992. His article was set against the background of clause 33 Finance (No. 3) Bill 2005. This article is not concerned with the effect of that clause on the “round the world schemes” at which it is aimed. It is concerned solely with the question of whether a “settlor”, who is not domiciled in the United Kingdom but who has made a settlement the trustees of which are resident in the United Kingdom for the purposes of capital gains tax, can claim the benefit of the relief accorded by section 12 Taxation of Chargeable Gains Act on gains accruing to those trustees on the disposal of assets situate outside the United Kingdom.
- 1.2 Robert Venables’ view as set out in paragraphs 2.2 to 2.5 of his article is that a fair result of the application of a purposive interpretation of sections 12 and 77 would be to secure exemption for such gains so long as they were not remitted to the United Kingdom. I agree. However, he went on to comment that the approach adopted by the Court of Appeal in *Bricom Holdings Limited v. Inland Revenue Commissioners* [1997] STC 1179 in construing the very different provisions of section 747 of the Income and Corporation Taxes Act and the Double Tax Treaty on which the taxpayer there relied, if applied to sections 77 and section 12, might well deny the settlor taxpayer of the benefit of section 12. This writer agrees that the reasoning of Millett, L.J. in that case might be adapted to achieve this result. But before taking that point further consideration should be given to the case for claiming relief under section 12.
- 1.3 It is, of course, necessary to keep in mind the fact that the circumstances with which we are concerned are not very likely to arise in practice. I use

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the words “not very likely” rather than “unlikely” because the latter expression might be interpreted as “nearly impossible”. What is envisaged is a settlement made by a person who is not domiciled in the United Kingdom (and who may indeed not have been domiciled at the time the settlement is made) on trustees who are themselves resident in the United Kingdom. It is unlikely that a non-domiciled settlor who wishes to dispose of assets situate outside the United Kingdom on the trusts of a settlement in which he retains an interest for the purposes of section 77 or 86 of the Taxation of Chargeable Gains Act would be advised to appoint as trustees persons who are resident in the United Kingdom. Such a settlor would almost certainly appoint as trustees persons resident outside the United Kingdom subject, of course, to there being no greater charge to tax on gains under the local law applicable where the trustees are resident. It might be said that a settlor who appointed United Kingdom resident trustees in such circumstances deserves to be visited by a charge to capital gains tax on the subsequent gain arising on the disposal by the trustees of overseas assets. Alternatively those advising him or their insurers deserve to be visited with any loss occasioned to the settlor (or rather the trustees from whom the tax can be recovered) as a consequence of this imprudent appointment.

- 1.4 But whilst the scenario envisaged may appear unlikely it is not impossible. The original assets in the settlement may consist of assets situate in the United Kingdom. Gains on the disposal of those assets cannot escape under section 12. It cannot be predicted that overseas assets the gains on which qualify for relief under section 12 will not be subsequently acquired. Again, although unlikely since section 77 envisages a United Kingdom resident settlor, the settlor may have been domiciled in the United Kingdom when the settlement was made but subsequently acquire a domicile outside the United Kingdom. Alternatively the death or removal of two or more overseas trustees may leave a majority of trustees who are United Kingdom residents or the settlor may wish to hold over the gain arising on the gift into the settlement.

Section 12

- 2.1 What then is the case for saying that section 12 affords an escape for the non-domiciled settlor for gains accruing to the United Kingdom resident trustees of the “settlor interested” settlements?

The starting point of the process needed to determine whether section 77 applies to the offshore gains of the United Kingdom resident trustees of a non-domiciled settlor is section 12 itself. Section 12(1) provides:

“In the case of individuals resident or ordinarily resident and not domiciled in the United Kingdom capital gains tax shall not be charged in respect of gains accruing to them on a disposal of assets situate outside the United Kingdom ... except such tax shall be charged on the amounts (if any) received in the United Kingdom in respect of those chargeable gains, and such amounts shall be treated as gains accruing when they are received in the United Kingdom.”

Sub-section (2) provides for the application of the provisions now found in sections 833 and 834 of the Income Tax (Trading and Other Income) Act 2005 to apply. It is beyond the scope of this article to deal with the question of whether and if so when a gain is remitted to the United Kingdom.²

- 2.2. Taken in isolation from the provisions of section 77 the wording of section 12(1) lends some encouragement to those who consider that the unremitted gains accruing on the disposal of assets by the United Kingdom resident trustees escapes the charge to tax imposed by section 77 on the non-domiciled settlor.
- 2.2.1 The sub-section does not provide that the gains accruing shall be gains accruing on the disposal of assets by the specific individual. It provides simply that tax shall not be charged in respect of gains accruing to the individual. Compare the wording of section 77 considered below which deems an amount equal to the trustees' gains to accrue to the settlor. It matters not that the individual has not himself disposed of the assets giving rise to the gain.
- 2.2.2 Furthermore this section does not provide that the amounts in respect of the chargeable gains shall be received by the individual who is to be charged. It is sufficient that amounts in respect of the gain have been received in the United Kingdom. Of course, without such receipt there can be no charge under section 12. If the United Kingdom resident trustees decided to cause the gains on the non-resident assets to be received

² There are a host of interesting problems arising: for example what happens if the non-domiciled taxpayer dies after disposal and the gains are remitted after his death?

in the United Kingdom there is nothing inconsistent in charging the non-domiciled settlor to tax in respect of the gains so remitted.

- 2.3.3 At least as a matter of inference – if only negative inference – section 12 provides support for the proposition that it applies to exempt gains to which section 77 otherwise applies.

Section 77

- 3.1 I turn to section 77 itself. In its amended form sub-section (1) provides as follows:

“where in a year of assessment –

- (a) chargeable gains accrue to the trustees of the settlement on the disposal of any or all of the settled property,
- (b) after making any deductions provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be chargeable to tax for the year in respect of those gains if
 - (i) the gains were not eligible for taper relief, but section 2(2) applied as if they were (so the order of deducting losses provided for by section 2A(6) applied); and
 - (ii) section 3 were disregarded; and
- (c) at any time during the year the settlor has an interest in the settlement

the trustees shall not be chargeable to tax in respect of those but instead chargeable gains of an amount equal to that referred to in paragraph (b) shall be treated as accruing to the settlor in that year.”

- 3.2 The only other provision which need be referred to as being relevant for is sub-section (7) which provides that the section does not apply unless the settlor is, and the trustees are, either resident in the United Kingdom during any part of the year or ordinarily resident.
- 3.3 It is unnecessary to refer other than briefly to the decision of the House of Lords in *West v. Trennery* [2005] STC 157 which was concerned with the

scope of the definition of “derived property” in sub-section (8). The decision is regarded as an illustration of the willingness of the courts to apply a wide construction to the provisions of section 77 with a view to securing that the gains with which the Court concerned considers should be brought within the charge are in fact caught. The very wide interpretation of the provisions which the House of Lords felt compelled to adopt obviously produces both absurdity and unfairness in a wide variety of cases³. But in this writer’s respectful view the House of Lords could probably not have come to any other decision. If meaning is to be attached to the words “derived property” it must surely mean something other than the settled property in which the settlor may or may not have an interest. “Derived property” is as capable of applying to money which is borrowed from the trustees on the security of the settled property and advanced to the trustees of another settlor interested settlement (as was the case in *West v. Trennery*) as it is to advances direct to the settlor.

3.4 The first point to make about section 77 is that it is clumsily drafted.

3.4.1 It begins by providing for a case where chargeable gains accrue to the trustees of a settlement from a disposal of any or all of the “settled property”. Of course it is plain what this means. It refers to the assets comprised in the settled property. But elsewhere in the Taxation of Chargeable Gains Act (e.g. section 1) the charge is imposed on gains accruing on the disposal of “assets”. And the position is no different in general where those “assets” form part of the settled property held by trustees. Sections 71 and 72 refer, for example, to “assets” forming part of the settled property not the settled property itself. However, leaving this inconsistency aside the meaning is plain; “settled property” equates to “assets” for these purposes.

3.4.2 Next the sub-section provides for a calculation of an amount on which those trustees would be chargeable if section 77 did not apply. It then provides that “the trustees shall not be chargeable to tax in respect of those”. “Those” can only be a reference to the chargeable gains which accrue to the trustees of a settlement from the disposal of the settled

³ The best illustration of unfairness is where a settlor who has been interested in the settlement receives a small part of the settled property (which is “derived property”) which he retains and then severs all interest with the settlement. The effect of the derived property provisions would appear to be that the settlor remains “interested” in the settlement so long as he retains the “derived property” and therefore potentially the subject of a tax on chargeable gains on subsequent gains accruing to the trustees regardless of the fact that he has no further interest in any part of the settled property. The fact that this is an obvious nonsense far removed from the mischief at which the provisions are aimed cannot be allowed to obscure the plain meaning of the words used.

property. But trustees, like individuals, are not chargeable to tax simply in respect of gains accruing to them. They are chargeable (see section 2(2) of the Taxation of Chargeable Gains Act) on the total amount of chargeable gains after deducting allowable losses. The charge is on a net amount of gains less losses: not simply on gains. The section would have been more happily worded if it had provided simply that the trustees were not to be chargeable to tax in respect of the amount referred to in paragraph (b) but that chargeable gains of that amount should be treated as accruing to the settlor instead.

- 3.4.3 Careless or even slovenly drafting cannot be taken as depriving a statutory provision of its intended effect where that intended effect is manifest. Equally, however, a carelessly worded provision ought not to be construed strictly so as to deprive a taxpayer of a relief where one would have expected that relief to be available unless the intent manifested by the provisions is clear.
- 4.1 The device at which section 77 is aimed, was a settlement of assets on trusts in which a settlor had an interest (usually a life interest) with power for the trustees to advance property to the settlor. At the time the measure was introduced gains accruing to the trustees of settled property attracted a lower rate of capital gains tax than gains accruing to individuals. The advantage of this lower rate which was enjoyed until recently by the trustees of “interest in possession” settlements has gone. Trustees of settlements, after allowing for the limited annual exemption which they enjoyed, are assessable to tax at 40%. Indeed it may be advantageous for the gains to be treated as the settlor’s gains under section 77 where reliefs are available to the settlor which are not available to the trustees⁴.
- 4.2 Section 77 might quite simply have provided expressly that the gains accruing to the trustees should be deemed to be the settlor’s gains. If the section had so provided the two objections which are the most potentially damaging to a contention that section 12 affords exemption would fall away and there is no doubt that a non-domiciled settlor would be enabled to take advantage of section 12 in exactly the same way as if the assets were in his own ownership.
- 4.3 Instead, however, the section provides for a calculation of an amount by reference to which the settlor is to be charged. The reasons are not clear. The requirement to disregard the provisions of section 3 (annual exempt

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Reliefs here do *not* include the availability of allowable losses.

provisions) as they apply to trustees is itself wholly consistent with a régime that deems the settlor to dispose of the assets himself and is necessitated by the fact that there is a requirement to calculate the amount on which the trustees would otherwise be chargeable before attributing the same to the settlor. The settlor's own losses are not available but are other provisions such as the EIS relief are available to relieve the chargeable gains attributed to the settlor by section 77.

- 4.4 Why then should it be supposed that section 77 has effect to deny the relief conferred by section 12 on chargeable gains accruing to the United Kingdom resident trustees that are deemed to be gains accruing to the non-domiciled settlor under these provisions?
- 4.5 The most obvious reason lies in the way the section is structured. As has already been remarked the settlor is not deemed to have made the disposals himself. The actual gains accruing to the trustees are not deemed to have accrued to the settlor. It is only the net amount of the gains accruing to the trustees (i.e. gains less trustees' losses) which accrues to the settlor as chargeable gains. Taken by itself that might not be enough to displace what would have been expected to be the intention of Parliament evident from a reading of the Taxation of Chargeable Gains Act as a whole: *viz.* thus non-remitted gains on the disposal of overseas assets should not be brought within the charge. However, the approach adopted by the Court of Appeal in *Bricom Holdings Limited v. I.R.C.* [1997] STC 1179 does not suggest that one could safely advise a non-domiciled settlor that section 12 would apply to exempt the gains otherwise chargeable under section 77.

Bricom

- 4.6 The *Bricom* case was concerned with different provisions and the Court predisposed to the view that section 12 did apply in cases such as this might well be persuaded to distinguish *Bricom*. But a comparison of the manner in which the provisions relied on in *Bricom* operated with that in which sections 12 and 77 operate in a case such as the present that demonstrates the significance of the decision. Essentially *Bricom* concerned a provision – section 747 of the Income and Corporation Taxes Act – as it applies to controlled foreign companies which bring the United Kingdom controllers of such a company within the charge to tax on an amount equal to the profits of the controlled foreign company. Section 747 can stand as the equivalent of section 77. The question which had to be decided was whether a provision in the double tax treaty with the Netherlands which exempted from United Kingdom tax interest arising in the United Kingdom which accrued to the foreign company could exempt

that part of the profits of the foreign company as were assessable on the United Kingdom “controller” under section 747. In the present case section 12 of the Taxation of Chargeable Gains Act assumes the role taken by the double tax treaty in the *Bricom* case. The reasoning of Millett, L.J. delivering what was effectively the judgment of the Court denying relief is at page 1195 (f) to (j).

“In my judgment these cases show that the question turns on the nature of the statutory process. Interest from exempt securities does not cease to be such by being included as a component element of the recipient’s taxable profits ... Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him ... But where tax is charged on a conventional or notional sum which exists only as the product of a calculation, the fact that one of the elements in the calculation is measured by reference to the amount of exempted income does not make the exempted income the subject of tax.

Applying those principles to the present case, I am in no doubt that the Special Commissioners were correct to dismiss the taxpayer company’s appeal. They held that the interest lost its character as interest by the end of stage 1 [the ascertainment of the overseas company’s chargeable profits]. I do not regard that as an accurate description of the statutory process. It is rather a reflection of the Revenue’s unsuccessful argument in Hughes viz: that interest from exempt securities loses its character as interest by being included in the computation of the recipient’s trading profits. The correct analysis is that the interest received by [the controlled foreign company] is not included in the sum apportioned to the taxpayer company on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer company and on which tax is charged.”

- 4.7 The case for claiming that section 12 affords no escape for gains attributed to the non-domiciled settlor under section 77 becomes clear from this passage. Section 77 does not deem the actual gains accruing to be the gains of the settlor. It treats as gains accruing to the settlor a notional amount being the aggregate of the gains accruing to the trustees of the settlement less the amount of any allowable losses. Since the gains on the

overseas assets are but one component in the calculation they are not to be treated as the settlor's gains. Accordingly the exemption cannot apply.

- 4.8 There is an obvious distinction between the charging and relieving provisions under consideration in *Bricom* and the provisions of sections 77 and 12 of the Taxation of Chargeable Gains Act. In *Bricom* the resident United Kingdom taxpayer was claiming treaty relief given to interest enjoyed by the "controlled foreign company" as an overseas resident. The effect of section 77 is that with the exception of the modification accorded to taper relief and the denial of the trustees' annual exemption the settlor becoming chargeable on the trustees gains under section 77 is entitled to the same reliefs accorded to those gains as the trustees themselves enjoy. The relief claimed by the non-domiciled settlor in section 12 is not one due to the trustees (who are in the position of the controlled foreign company). In that respect *Bricom* may be distinguished. In *Bricom* the United Kingdom taxpayer company had to satisfy the court not merely that the relieved interest was an identifiable part of the income attributed to it under section 747 but also that it was entitled to the benefit of a relief which was enjoyed by its wholly owned Netherlands subsidiary but which would not be enjoyed by it as the United Kingdom parent. All the settlor taxpayer has to do in the case of sections 12 and 77 is to satisfy the court that gains made on disposals of overseas assets by the trustees are to be treated as gains accruing to the settlor.
- 4.9 The charge under section 747 is on an amount which would be the corporation tax chargeable on the profits of the controlled foreign company. To bring himself within the treaty exemption the United Kingdom controller of the company had to demonstrate
- (a) that the interest exempted by the treaty could be disentangled from the remaining part of the profits of the company and accorded exemption;
 - (b) that the assumption required to be made by Schedule 24, paragraph 1(1) to the Income and Corporation Taxes Act: *viz* that in order to enable the chargeable profits of the controlled foreign company to be ascertained it is assumed to be that the controlled foreign company was "resident in the United Kingdom" should be modified or ignored so as to enable the treaty exemption accorded to interest where it was paid to a non-resident to apply.

So far as (a) is concerned Millett L.J. said at page 1194f:

“the “chargeable profits” [by reference to which the United Kingdom controller is to be charged is defined as] a purely notional sum”.

By contrast the amount of the chargeable gains to which section 77 refers is not purely notional. They represent actual gains which otherwise accrue to the trustees. No assumptions need be made for these purposes. The calculations required under section 747 involve several stages which are removed from the relatively straightforward application of section 77.

So far as (b) is concerned no assumption or fiction is created by section 77 which would require, for example, any United Kingdom taxpayer settlor to have some other character than that of a non-domiciled settlor for these purposes.

- 4.10 In this writer's view *Bricom* can be distinguished on those grounds and, but for a factor which has yet to be mentioned, the Court could be persuaded to apply the exemption accorded by section 12 to gains on overseas assets which accrue to the trustees and which form a component part of the total gains (less losses) attributed to the non-domiciled settlor under the provisions of section 77.

The statutory fiction

- 5.1 The main ground for supposing that section 12 affords relief to gains attributed to the non-domiciled settlor under section 77 lies in the interpretative process consequent upon the application of the statutory fiction embodied in section 77.

The observation on the interpretation of a deeming provision most commonly relied on is that of Lord Asquith in *East End Dwellings Co. Ltd v. Finsbury B.C.* [1952] AC 109 at 132-3.

“If you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it...the statute says that you must imagine a certain state of affairs; it does not say that having done so, you must cause

or permit your imagination to boggle when it comes to the inevitable corollaries of that state of affairs.”

- 5.2 The statutory fiction in section 77 does not go so far as to attribute the actual gains accruing to the trustees to the settlor. If it had done so there would be no problem in the application of section 12. Instead it attributes to the settlor a sum equal to the net gains. Nonetheless, by contrast to the *Bricom* case, there is a direct link between the actual gains which accrue on disposals by the trustees of settled property and the self same gains which are then effectively attributed to the settlor. Effectively section 77 attributes the actual gains accruing to the trustees to the settlor in precisely the same way as if the statute has expressly so provided. But for what follows the availability of relief under section 12 is an inevitable corollary of the application of section 77 and those who argue to the contrary would rightly be accused of causing or permitting their imagination to boggle.
- 5.3 The substantive obstacle in the way of a claim for relief is this: section 77 requires the computation of the gains accruing to the trustees less the allowable losses which accrue to them. The allowable losses accruing to the trustees include losses on disposals of assets situate outside the United Kingdom. Section 16(4) of the Taxation of Chargeable Gains Act provides that such losses if accruing to a non-domiciled individual are not allowable losses. Whilst the imagination might not boggle at the claim for relief on gains which are effectively attributed to the non-domiciled settlor under section 77 imagination begins to falter when it is discovered that the apportionment process would appear to allow a settlor to claim the benefit of losses which, if they had accrued to the settlor on the disposal of such non United Kingdom assets would not have been allowable in his hands⁵.

⁵ Allowable losses accruing to the settlor are not deductible from gains attributed to him under section 77 but this is immaterial in this context.