The Offshore & International Taxation Review

UK FINANCE BILL AND TAX PLANNING FOR OFFSHORE TRUSTS

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1 Scope of the Article

In this article, I discuss changes to United Kingdom tax law which are being enacted in the current Finance Bill and which are likely to have an impact on international tax planning involving trusts. Where appropriate, I also refer to changes which might perhaps, but have not been, made and which strategies, or variants thereon, remain viable.

2 Emigration of Trusts[2]

2.1 Deemed Disposal by Trustees

Trustees who become neither resident nor ordinarily resident in the UK are deemed to dispose of the settled property and reacquire it for a market value consideration: Taxation of Chargeable Gains Act 1992 section 80. This rule is not itself being changed by the Finance Bill.

2.2 Election for Holdover Relief

I suggested in my *Non-Resident Trusts*, at 12.4, that, as a matter of technical law, it was arguable that emigrating trustees could, in a suitable case, elect for holdover relief so that the effect of section 80 would be nullified. This would

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2 See generally my *Non-Resident Trusts* Chapter 12.

normally be possible, for example, where the trust fund consisted of shares in a private trading company. My reasoning depended on the argument that the deemed disposal was not a disposal at arm's length and the trustees received only deemed, not actual, consideration.

This argument has received an indirect boost from the new Schedule 4A being inserted in the Taxation of Chargeable Gains Act 1992. That Schedule, which is referred to at 4.5.2 below, operates, in much the same way as does section 80, by deeming the trustees of a settlement to make a disposal of settlement property for a market value consideration. It is expressly provided, however, that the deemed disposal is to "be taken ... to be a disposal under a bargain at arm's length."[3] The only purpose of this provision is to prevent holdover relief from being claimed. The draughtsman obviously thought that unless it were inserted the trustees would be able to claim holdover relief.

2.3 Strategies using value splitting

It is possible to gift a small part of an asset to several separate United Kingdom resident settlements and elect for holdover relief.[4] When the settlements emigrate, each set of trustees will be deemed to dispose of and reacquire their own settled property at market value. That market value will not take into account the value of property in the other settlements. Thus, where value is destroyed by fragmentation, in that the sum of the values of the holdings of each trust is less than the value of the whole, the gain which is charged to tax on emigration can be reduced or even eliminated. This strategy could be useful where the property to be gifted consists of a controlling holding in a non-quoted company. See my *Non-Resident Trusts* at 7.2.3 The Finance Bill does not counter this strategy.

2.4 Value Reducing Strategies

More sophisticated strategies involve the artificial depression of the value of trust assets during a period which includes the time of emigration. The Finance Bill does not counter these strategies either.

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3 Paragraph 9(1)(b).

4 Where holdover relief is not available, Taxation of Chargeable Gains Act 1992 section 19 needs to be taken into account.

2.5 Temporarily Immigrant Trusts

Where a trust becomes United Kingdom resident by the death of a trustee and ceases to be so resident within six months, there is no deemed disposal of settled property on emigration, subject to certain exceptions. See my *Non-Resident Trusts* at 12.6.3. There is a loophole under which certain types of property can be gifted into the trust structure without a charge to capital gains tax either at the time of the gift or the time of the emigration. The loophole is blocked (probably unintentionally) by the Finance Bill as regards gifts of shares and securities.

2.6 Exploiting the Bed and Breakfast Rules for Quoted Securities

It is arguable that the rules for identifying securities disposed of for the purposes of capital gains tax operate so as to negative the section 80 deemed disposal on the emigration of a settlement. See my article in *The Personal Tax Planning Review* Volume 7, Issue 3, *Repeal of the Charge on Emigration of Trustees?* The Finance Bill contains nothing to counteract this result.

2.7 United Kingdom Resident Trusts becoming Dual Resident

Where United Kingdom resident trustees become dual resident, Taxation of Chargeable Gains Act 1992 section 83 deems the trustees to dispose of certain trust assets. It applies only if the trustees become at any time trustees who fall to be regarded for the purposes of any double taxation relief arrangements (a) as resident in a territory outside the United Kingdom, and (b) as not liable in the United Kingdom to tax on gains accruing on disposals of "assets ("relevant assets") which constitute settled property of the settlement and fall within descriptions specified in the arrangements."

The trustees are deemed for capital gains tax purposes to have disposed of their relevant assets immediately before the time concerned and immediately to have reacquired them at their market value at that time.

Strategies relevant to the similar section 80 deemed disposal on emigration are in principle operative in this context too.

One argument, which is not addressed by the Finance Bill, is available where the double taxation convention firstly provides that the United Kingdom may tax certain gains of a non-UK resident and then provides that, subject thereto, gains from the alienation of property shall not be taxable in the United Kingdom. In such a case, it is arguable that the assets on a disposal of which the trustees are protected from United Kingdom capital gains tax are not "assets ... which ... fall within descriptions specified in the arrangements"; rather, the contrary is the case in that the assets which fall within descriptions (e.g. United Kingdom situate land) are the ones which are not exempted from United Kingdom capital gains tax and the assets which are exempted are exempted by the general rule and not because they fall within any specified description.

3 Indirect Gifts to Non-UK Resident Settlements

A gift of an asset to a non-UK resident settlement is normally deemed to be for a market value consideration. A strategy, colloquially referred to as "the envelope trick", was devised whereby a non-UK resident settlement would be established with a small fund of cash and the trustees would acquire a shell United Kingdom holding company. The settlor would then gift to the company valuable assets and would make an election for holdover relief from capital gains tax. The trustees would then sell the shares in the holding company. In this way, the charge to tax on the gift of the substantial assets would be deferred indefinitely.

The strategy was subjected to successive rounds of anti-avoidance provisions. The history and current status of the strategy as of March 9th 1999 is discussed in my *Non-Resident Trusts* at 12.9.

The Finance Bill very much reduces the scope of the strategy by abolishing, with effect from November 9th 1999, holdover relief on a gift to a company of shares or securities in a trading company. The strategy is still viable in the case of the gift of (a) an asset used for the purposes of a trade, profession or vocation carried on by the transferor, or his "personal company" or a member of a trading group of which the holding company is his personal company of (b) agricultural land qualifying for agricultural property relief from inheritance tax.

4 Disposals of Interests in Settlements

4.1 The General Rule

The general rule is that the disposal of an interest in a settlement is exempt from capital gains tax unless it has been acquired for a consideration. Since 1981, this rule has not applied to the disposal of an interest in a non-UK resident trust.

Since March 6th 1998, it has not applied to the disposal of an interest in a trust which has been non-UK resident.[5]

4.2 Sale of Interest in Non-UK Resident Settlements

Capital gains realised by non-UK resident trustees can be visited on beneficiaries who receive "capital payments" from the trustees.[6] One strategy was for a beneficiary to sell a substantial interest under a trust to a non-UK resident. The sale of the interest would, before 1981, have been exempt from capital gains tax. The interest would normally be such that in due course the non-resident would become absolutely entitled to the trust fund. While he would then realise an actual capital gain on the deemed disposal of his interest in consideration of receiving the settled property and in addition gains realised by the trustees on or before his becoming absolutely entitled would be imputed to him, this would be of no concern to him as he would not be liable to capital gains tax on account of his not being United Kingdom resident.

4.3 Sale of Interest in Immigrant Settlement

Between 1981 and 1998, the variant on the original scheme was that the trustees would dispose of their assets in one year and become United Kingdom resident in the following year. Only then would the sale take place. This variant ceased to be viable on March 6th 1998.

4.4 Sale of Interest in Immigrant and Emigrant Settlement

A further variation of the strategy which then came into use was for the trustees, having become United Kingdom resident, to cease to be so resident. It was considered that on the emigration, the beneficiary would obtain a new market value base cost for his beneficial interest, so that if he sold it shortly afterwards he would realise no or little gain: Taxation of Chargeable Gains Act 1992 section 85(3). The Finance Bill counters this strategy by denying the uplift in the beneficiary's base cost where, at the time of the trustees' emigration, the settlement has "relevant offshore gains". These are in effect trust gains which can be imputed to beneficiaries. As the imputation of gains is done on a yearly

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5 See my *Non-Resident Trusts* 15.1.

6 Taxation of Chargeable Gains Act 1992 section 87. The section does not apply to trust gains which have been visited on the settlor under section 86 or to gains of certain trusts with non-UK domiciled or resident settlors which were realised before March 17th 1998.

basis, one asks whether there would be any outstanding trust gains if the year had ended immediately before the emigration.

4.5 Remaining Strategies

4.5.1 Limited Proceeds of Disposal

Strategies which are not counteracted by the Finance Bill involve the beneficiary making a non-exempt disposal of his interest but not realising any, or any substantial, capital gain, because the deemed proceeds of disposal are modest.

4.5.2 Exemption of Disposal by Taxation of Chargeable Gains Act 1992 Schedule 4A

Schedule 4A is being introduced into the Taxation of Chargeable Gains Act 1992 by the Finance Bill Schedule 24. It is called "Disposal of Interest in Settled Property: Deemed Disposal of Underlying Assets". Its purpose is to drive further nails into the coffin of a scheme which had already been spiked by restrictions on holdover relief announced in the November 1999 mini-budget. Where there is a disposal for value of an interest in certain settlements, the trustees are deemed to dispose of and reacquire the (relevant part of the) settled property for a market value consideration. While the Schedule normally applies only to United Kingdom resident trusts, it can apply to trusts which are non-UK resident but have been United Kingdom resident in the past.

Paragraph 10 of the Schedule is headed "Avoidance of double-counting". No chargeable gain is treated as accruing on the disposal of the interest in the settlement provided that the chargeable gain on the disposal of the interest would be less than the net chargeable gain on the deemed disposal by the trustees. This might conceivably form the basis of tax planning in a suitable case where the settlement has in the past been non-UK resident and has stockpiled section 87 trust gains. The complexities of such planning should not be underestimated.

5 Flip-Flops

5.1 The Perceived Mischief

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.[7] 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. In the next year of assessment, capital gains would be realised by the trustees.

There were several versions of the scheme. If the purpose was simply to avoid the United Kingdom Settlor Provisions or the Offshore Settlor Provisions, after the appointment in Year 1, the trusts would be modified so as to ensure that the relevant 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 years of assessment.[8] 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.

5.2 The Budget Press Release

In the Inland Revenue 2000 Budget Press Release of 21st March 2000 Capital Gains Tax: Countering Avoidance Using Trusts,[9] it was stated:

> "Trustees in debt
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> 7. The third element in the package is designed to counter an avoidance device which has become commonly known as a "flip flop". This is a device for extracting gains from a trust tax-free or with a significant tax saving. At its simplest, the trustees of a trust in which a UK resident settlor has an interest (so that the settlor is charged in respect of trust gains) borrow money on the security of assets in the trust and advance the money to another trust. The settlor then severs his interest in the first trust. In the following tax year the trustees sell the assets and use the proceeds to repay the debt. The settlor receives his money from the second trust. If successful, the outcome of the device is that in the

7 See my *Non-Resident Trusts* Chapters 11.6.4, 13, and 14 respectively.

8 For the transfer of section 87 trust gains from one settlement to another see my *Non-Resident Trusts* Chapter 14.

9 REV 15.

case of an offshore trust no tax is paid by the settlor. In the case of a UK trust there is a 6% tax rate saving for the higher rate taxpayer. The device can also be used to eliminate entirely the CGT liabilities of UK beneficiaries of offshore trusts who receive capital payments from trustees.

"8. From today, where trustees, at a time when they are in debt, transfer funds to another person (whether by transferring or lending property) and any borrowed money has not been wholly used for normal trust purposes, the trustees will be treated as making a disposal and reacquisition of settled property. They will be deemed to dispose of the whole (or, where the amount transferred is less than the value of the chargeable assets remaining in the trust, an appropriate fraction) of those remaining assets at the time of the advance, and immediately reacquiring them at market value. Gifts hold-over relief will not be available on the gains arising on this disposal."

5.3 The New Schedules

5.3.1 Interaction of Schedules

The Finance Bill introduces into the Taxation of Chargeable Gains Act 1992 two new schedules, Schedule 4B and Schedule 4C. Schedule 4B causes the trustees of a settlement to be deemed to dispose of (and reacquire) settled property for a market value consideration. Schedule 4C applies only where the result of Schedule 4B applying is that the trustees realise section 87 gains.

5.3.2 General scheme of Schedule 4B

Schedule 4B applies where:

the trustees of a settlement make a "transfer of value";

in a year of assessment in which the settlement is within Taxation of Chargeable Gains Act 1992 section 77, 86 or 87; and

the transfer is "linked with trustee borrowing".

The result of the section applying is that the trustees are treated as disposing of and immediately reacquiring the whole or a proportion of each of the chargeable assets which continue to form part of the settled property.

The Schedule is unnecessarily complex and very badly drafted. In some ways it is too wide and in other ways too narrow. If it is enacted in its current form, variants on the flip-flop strategy should still be successful.

5.3.3 General scheme of Schedule 4C

If Schedule 4B stood alone, some planning would still be possible. Trustees could always realise in one year a part of the trust fund, perhaps that which had the least unrealised capital gain, and appoint out the proceeds to another trust. Provided they made no further disposals in that year, only a proportion of the trust gains for the year would be attributed to the transferee trust. With careful planning, this could often be a much smaller share than the share which in fairness ought to have been carried over to the new trust. *This strategy remains perfectly viable.*

If, on the other hand, there is no actual disposal by the trustees, but there is a Schedule 4B deemed disposal, then Schedule 4C requires the gains realised on that deemed disposal to be ring-fenced and attributed to beneficiaries of either the transferor or the transferee settlement who receive capital payments. Thus, all the gains, not merely a part of them, as in the case of an actual disposal, can be visited on beneficiaries of the transferee settlement.

In a suitable case, Schedule 4C can be used as an instrument of tax planning. Section 87 does not apply to gains to which Schedule 4C applies. Schedule 4C does not apply to all capital payments made to beneficiaries. Hence it is possible, by deliberately bringing Schedule 4B into play, to ensure that a capital payment made to a beneficiary no longer results in a capital gain being attributed to him under section 87. Conversely, given that ring-fenced gains are not transferred to the new settlement, it is possible to avoid any gains being attributed to the beneficiaries of that settlement under Schedule 4C, even if they receive capital payments from the trustees.

6 Utilisation of Trust Losses Post Budget 2000[10]

6.1 Health Warnings

All the strategies mentioned in this section have inheritance tax implications. While inheritance tax need not be a problem, extreme care must be taken to

10 For the position post Finance Act 1999 and pre Budget 2000, see my article *Capital Losses and Trusts* in *Personal Tax Planning Review* Volume 7, Issue 2, page 109.

ensure that capital gains tax planning does not result in unacceptable inheritance tax charges. The inheritance tax position is beyond the scope of this article. Advice can be given only on a trust by trust basis.

Trust law considerations must be taken into account in implementing any of the strategies, especially where the trustees are exercising dispositive powers.

6.2 Pre June 16th 1999

Allowable losses of trustees could, until June 16th 1999, be transferred to beneficiaries who became absolutely entitled to settled property representing property in respect of which an allowable loss had accrued to the trustees. In simple versions of the strategy, such property was transferred to an "original" beneficiary. In more sophisticated versions, losses were sold to "new" beneficiaries who were able to utilise them. This might involve the sale of a beneficial interest in the trust property which would shortly ripen into an absolute interest or the appointment of trust property to the "purchaser" for a consideration. This strategy was largely curtailed by the amendment of Taxation of Chargeable Gains Act section 71(2) by Finance Act 1999. While it is of no direct relevance to non-UK resident trusts as a loss of trustees is normally only an "allowable" loss if the trustees are United Kingdom resident for at least part of the year in which the loss is realised, it was sometimes possible to create an allowable loss by the immigration of the trust.

6.3 Alternative Planing: Transfers of Gains To Trustees

Although trust losses cannot be transferred to beneficiaries, one can still ensure that future gains arise in trusts with unutilised losses. This strategy works in principle for trusts which are never United Kingdom resident. Although losses sustained by such trusts are not "allowable" losses, they can still be utilised to reduce trust gains taxable on the settlor or the beneficiaries under Taxation of Chargeable Gains Act 1992 section 86 or 87.

A simply strategy would be for the trustees to invest for capital growth. One would ensure that the trust does not end prematurely, otherwise the losses could be "stranded".

There is no objection in principle to further funds being added to the settlement, whether by the original or a different settlor. Provided care is taken, one need not thereby create a new settlement for capital gains tax purposes.

It does not matter if the United Kingdom Settlor Provisions or the Offshore Settlor Provisions apply to the settlement. In each case, the settlor is only chargeable on an amount of trust gains after deduction of allowable losses.

A more sophisticated strategy would be to make the trust United Kingdom resident and then gift to it an asset pregnant with gain and make an election for holdover relief. The trustees could then sell the asset if they thought fit and the losses could be set off against the heldover gain. This variant of the strategy would normally depend on the losses of the trustees being "allowable" losses, i.e. realised in a year in some part of which the trustees were United Kingdom resident. If they were not, it would be necessary to ensure that the gain was realised by the trustees only in a year in no part of which they were United Kingdom resident. This would involve circumventing the charge which would normally arise on their emigration: see section 2 above.[11]

6.4 Sale of Trust Losses

6.4.1 Methods

It is possible in principle for trust losses to be "sold" by beneficiaries of an existing trust selling their interests to a stranger who will then ensure that the trustees realise capital gains. The strategy for the transfer of losses to an individual involved the trust coming to an end, at least as regards part of the settled property. Now, the trust must continue as a "settlement" for the tax advantages to be obtained, which complicates the planning, especially the inheritance tax planning, and makes it more important than ever for advice to be taken on a trust by trust basis.

6.4.2 Sale of a Beneficial Interest

One method of selling trust losses is for one or more beneficiaries to sell to the purchaser interests of theirs under a trust which are already in existence or which are specially created, e.g. by the exercise by the trustees of their dispositive powers.

A charge to ad valorem stamp duty at a rate of up to 4% can, since the Budget 2000 Speech, arise on the sale of a beneficial interest by a beneficiary unless steps are taken to avoid it.

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[11] For the position where trust losses have been "sold", see 6.4.2 below.

The sale of an interest in a trust which is or has been non-UK resident is not exempt from capital gains tax. This may not be a problem, in that the vendor beneficiary may not be United Kingdom domiciled and resident at a relevant time. Alternatively, his base cost may be so high that he does not realise a gain. If the vendor would otherwise be liable to capital gains tax on a sale of his interest, it might be possible to avoid the tax by a strategy such as that mentioned at 4.5 above.

If the trust is United Kingdom resident at a relevant time, the new Taxation of Chargeable Gains Act 1992 Schedule 4A, could in principle apply to the sale of a beneficial interest in it. In the circumstances posited, i.e. that there is an excess of trust losses over trust gains, realised or unrealised, this will not normally be a problem as all the Schedule does is to cause the trustees to realise unrealised capital gains.

If an interest is sold and the "purchaser", i.e. the person who acquired the interest or entered into an arrangement to acquire the interest, or any person with whom the purchaser is connected, disposes of an asset ("the gifted asset") to the trustees and makes an election for holdover relief, then the trustees cannot set off any losses against the gain arising on the disposal of the asset.[12] This is doubly penal in that (a) no loss can be set off against a gain which has accrued during the trustees' period of ownership of the gifted asset and (b) a loss cannot be set off against the gain even to the extent to which the loss accrued during the same period.

6.4.3 No Sale of Beneficial Interest

It may be possible to implement the strategy without any disposal of an interest in settled property. The trustees would create fresh beneficial interests in the "purchaser" and a person connected with him and one or more beneficiaries under the trust would receive compensation from the purchaser. While the doctrine of fraud on the power would have to be watched, this would in a suitable case work as a matter of trust law.

Possible advantages are:

there would be no ad valorem stamp duty payable;

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12 Taxation of Chargeable Gains Act 1992 section 79A, which is being added by the Finance Bill.

the recipient beneficiary would not sustain a charge to capital gains tax on the disposal of his interest;

Taxation of Chargeable Gains Act 1992 Schedule 4A would not be brought into play and

the purchaser may be able to transfer assets to the trustees (if United Kingdom resident) under an election for holdover relief without the trustees being prevented from setting off their historic losses against the gain arising on the disposal of such assets.

7 Attribution of Capital Gains of Non-UK Resident Companies[13]

7.1 Pre Budget 2000

Gains of an offshore quasi-close company ("OCC") can be apportioned to "participators", direct or indirect, of such a company: Taxation of Chargeable Gains Act 1992 section 13.

The Revenue agreed that if the gain of the OCC is relieved from capital gains tax/corporation tax by a double taxation convention, then section 13 cannot apply to it.

7.2 Trustee Participators Post Budget 2000

The Finance Bill is adding to Taxation of Chargeable Gains Act 1992 a new section 79B, which is intended to stop double taxation relief from preventing the OCC provisions applying in a case where trustees are, directly or indirectly, participators in the offshore close company. It removes treaty immunity not only from trustees, but also from settlors and beneficiaries to whom trust gains are attributed by the United Kingdom Settlor Provisions, the Offshore Settlor Provisions or the Offshore Beneficiary Provisions.

The enactment of section 79B involves the deliberate and flagrant violation of many treaties to which the United Kingdom is a party.[14] Under our constitution, there can be no challenge to its validity on that ground. It is noteworthy that it is

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13 See my *Non-Resident Trusts* Chapter 15A.

14 Those who seek to play down the perfidy involved, prefer to speak of "treaty override".

being introduced by the very same government which has secured the passing of the Human Rights Act.

Section 79B is capricious in its incidence. It does not remove the immunity in the case of participation by individuals or estates otherwise than through a settlement. Nor does it strictly speaking remove the immunity of a company. What it does do is to prevent trustees interposing between themselves and the OCC a United Kingdom resident company which would itself be taxable on part of the apportioned gain of the OCC but for the treaty immunity. It allows the gain apportioned to such a company to be sub-apportioned to the trustees and then denies them the benefit of the immunity.