The Offshore Taxation Review

FINANCE ACT 1998 SECTION 130: AVOIDING MR ROBINSON'S SECTION

Stephen Brandon QC[1]

Introduction

1. Section 130 of Finance Act 1998 has the potential to cause chaos for a number of substantial private trusts, where some of the beneficiaries are domiciled and resident in the United Kingdom. Its effects, however, can be avoided but avoidance requires, first, a clear understanding of the regime set out in the Taxation of Chargeable Gains Act 1992 ("TCGA"), section 87.

2. The amendment to section 87 by section 130 is remarkably simple: all reference to the domicile of the settlor is removed. All settlements are therefore potentially within the ambit of the section 87 regime, the only qualification being that trust gains accruing before 17th March 1998 (and capital payments made before then) are ignored: sub-section (4). This is likely to provide a window of opportunity for beneficial restructuring.

Simple Washing of Gains

3. It is trite to point out that trust gains can be "washed" by appointing or advancing an amount equal to those gains to a foreign domiciled beneficiary. This is because such payments still count as capital payments made, although they are not chargeable: section 87(7). While such "washing" is being suggested as a way of mitigating section 130, its uses are very limited.

4. This is obvious from examining how trust gains and capital payments are matched. "Unmatched" trust gains can be carried forward. All trust gains accruing in the year of assessment and those carried forward constitute the

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"trust gains for the year" within section 87(2). These are matched with capital payments according to sub-section (5), which provides that:

> "The attribution of chargeable gains to beneficiaries under subsection (4) above shall be made in proportion to, but shall not exceed, the amounts of the capital payments received by them."

Thus, the matching is made on a proportionate basis.

5. The other significant factor is sub-section (6), which provides that capital payments made in previous years are only disregarded if previously matched with a trust gain. Thus, capital payments are carried forward as well.

6. To take a simple example:

6.1 If, in year 1, a £1,000 trust gain is made in June, £1,000 advanced to a non-UK domiciled beneficiary in August and £1,000 to a UK domiciled beneficiary in September, the UK beneficiary's chargeable gain is

$$\frac{£1{,}000}{£2{,}000} \quad \text{X} \quad £1{,}000 = £500$$

;

6.2 Alternatively, if the £1,000 is advanced to the non-UK beneficiary in year 1 and the £2,000 advanced to the UK beneficiary in year 2, there is no trust gain to be matched with the capital payment to the UK beneficiary.

Thus, we have potential for a simple "clear out". Its limited use, however, is seen if the example in 6.2 is continued:

6.3 In year 3, a £1,000 trust gain is made and £1,000 is appointed to the non-UK beneficiary. Both the capital payment made in Year 3 *and* the unmatched capital payment previously made to the UK beneficiary in Year 2 fall to be matched with the trust gain on an apportioned basis:

$$\frac{£2{,}000}{£3{,}000} \quad \text{X} \quad £1{,}000 = £670$$

so that a £670 gain accrues to the UK beneficiary.

Thus, the "simple washing scheme" is no good in an ongoing situation.

More Complex Washing: Through a New Trust

7. The next requirement is to break the nexus between trust gains and capital payments altogether. This can be achieved by advancing/appointing part of the trust fund to a new settlement. (Easily said, but the terms of the original settlement ("Settlement 1"), the relevant proper law and the *Roome v Edwards* line of authorities will require careful consideration. The drafting of the appointing/advancing instrument will also need considerable care). If properly effected, the appointment/advancement will not itself give rise to a capital payment, nor should Settlement 1 and the new settlement ("Settlement 2") comprise a single settlement within the extending definition of TCGA, section 97(7).

8. The provision to avoid here is TCGA, section 90. What this does, however, is to attribute trust gains for the year in Settlement 1 to the trustees of Settlement 2. It does *not* match subsequent trust gains in Settlement 1 with capital payments made out of Settlement 2. Thus, assuming no trust gains in Settlement 1, after 17th March 1998, an appropriate part of the trust fund can be appointed to Settlement 2 (this must be done without, of course, triggering a trust gain) so that capital payments made out of Settlement 2 will not be matched with trust gains in Settlement 1. (Strictly, the trust gains for the year of Settlement 1 will include all gains made in the current year of assessment but, fortunately, gains can, *for the purposes of section 90*, be "washed" if any are made in this year).

9. This allows capital payments out of Settlement 2 to be made without incurring a charge levied by reference to the trust gains of Settlement 1. What about gains made in Settlement 2? Unless Settlement 2 is to be a mere conduit (which would require careful administration of Settlement 1 as well as the close watching of the *Ramsay* principle) we will also need to secure that there are no future trust gains in Settlement 2.

Avoiding Trust Gains in Settlement 2

A Treaty Resident Settlement?

10. Can we simply position Settlement 2 in a treaty area? TCGA, section 13 (apportionment of gains made by foreign resident companies) is tamed by appropriate treaty relief and there is a good argument (of the merits of which the Revenue has yet to be persuaded) that TCGA section 86, despite *Bricom*, may also be defeated by treaty relief. I can, however, see no tenable argument that, in *these* circumstances, a beneficiary taxed on a capital payment under section 87 can claim treaty relief by reference to a trust gain accruing to the trustees of Settlement 2.

Scope for securing income, not gains?

11. Can we avoid section 87 applying to Settlement 2 by taking income, not gains? The argument is that, after the interpretation of ICTA 1988, section 741, set out in *Willoughby*, section 741 may offer protection for such settlements against attack under section 740. A settlement created merely for the purposes of securing inheritance tax protection for foreign assets may well, after *Willoughby*, fall within the protection of section 741. The problem is that, to create income, not gains, needs an underlying entity, typically, a company, and *it* will presumably, make chargeable gains. These are potentially subject to section 87, through section 13 (see section 13(10)). While, as noted, section 13 can be avoided by treaty arrangements, if a gain traced through via section 13(10) matches a capital payment caught by section 87, the beneficiary will not, in my opinion, be able to claim treaty relief. Further, even creating the new underlying structure will *itself* potentially be a "transfer of assets" which will cause income to become payable and, viewed by itself, will presumably not be within the protection afforded by section 741. The "turn gains into income" route is likely to have only a limited application.

The Alternative Route

12. What, very briefly, is therefore needed, is that Settlement 2, and its underlying entity, should be structured first, so that section 740 is avoided, in relation to the UK resident beneficiaries and, secondly, that no trust gains are traced through back to the trustees of Settlement 2. This can be done by appropriate structuring of an entity not subject to section13, with the rights in it structured so that no gains arise on the disposal of those rights by the trustees of Settlement 2 (in this particular instance, however, treaty relief is unlikely to provide the answer).