The Offshore Taxation Review

WHERE IS AN INTEREST IN A UNIT TRUST SITUATED?

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1 Scope of the Article

Adrian Shipwright and Julian Ghosh have suggested in a leading article 'Non-UK Unit Trusts: Inheritance Tax Implications for Non-UK Domiciliaries' in Volume 4, Issue 1, page 1 of *The Personal Tax Planning Review*, that the interest of a unit holder in a unit trust is situate where the register is kept. The position is thus, in their view, assimilated to that of a shareholder in a corporation. While the view of either of these gentlemen is entitled to considerable respect and their joint view is entitled to very considerable respect, I suggest in this article that the contrary may not be unarguable and that international tax planning which proceeds on the basis that the Shipwright/Ghosh view is correct may be risky, unless the governing trust law is very different from English law or unless the documentation is appropriately worded.

2 Uses of Unit Trusts

Unit trusts may be used purely for tax planning purposes. Even where they are used for commercial purposes, tax considerations will normally loom large. The question of the situs of the interest of the unit holder in a unit trust will normally be relevant for the purpose of capital taxes, the territorial scope of which is often determined by reference to the situs of assets. It is with that aspect that the Shipwright/Ghosh article was primarily concerned and which is the central point in this article. The correctness or otherwise of the Shipwright/Ghosh reasoning is, however, by no means confined to capital taxation. It could be equally important for the taxation

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of income and capital profits and gains.

3 A Classic Tax Planning Problem

It may help the reader to concentrate on a concrete illustration. Mr and Mrs A, domiciled in Ruritania and ordinarily resident only there, wish to invest in UK quoted equities. They are concerned to ensure that their investment will not be subject to inheritance tax on their deaths. One classic way of doing this is for them to own the equities via a corporation established in a tax haven, say, Guernsey. What they will own will be shares in the Guernsey investment company, which shares can only be dealt with by an appropriate entry in the books of the company, which are kept at St. Peter Port, and will thus, on traditional learning, constitute property situate in Guernsey, notwithstanding that all the assets of the Guernsey company are themselves situate in the United Kingdom.

4 The Foreign Corporation as a Solution

This classic solution would usually be the most appropriate to solve this particular problem. True, the Privy Council in *Kwok Chi Leung (Executor of Lamson Kwok) v Commissioner of Excise Duty*[2] hinted that such arrangements might one day need to be reconsidered in the light of the *Ramsay* principle, yet that does not seem to have deterred any taxpayers. Rightly, see my *Inheritance Tax Planning* 3rd edition at B.5.3. Not surprisingly, some jurisdictions have artificial rules which deem to be situate within their jurisdiction for capital tax purposes shares in a company the majority of the assets of which are situate in the jurisdiction. Care must always be taken to check whether such a provision may be in force in a particular jurisdiction. If it is, I for one would be loath to rely on a form of tax planning which defies the tax authorities of the jurisdiction to collect the tax.

A unit trust might be thought to be as, or more, desirable than a corporation. The new UK transfer pricing provisions, introduced by Finance Act 1998, can arguably catch cases where individuals benefits from companies but not where they receive benefits from trusts. See my article 'The Transfer Pricing Provisions and Benefits From Offshore Structures' at page 165 of this issue.

5 What is A Unit Trust?

The term "unit trust" has no precise definition. It may well be that there are entities or arrangements which one could design - and possibly have in fact been designed and are now in operation - in different parts of the world which are called "unit trusts" but do not have what in my view are the essential characteristics of unit

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2 [1988] STC 728.

trusts. The reader should therefore be warned that the answer to the question could vary from unit trust to unit trust.

In my view, the first essential characteristic of a unit trust is that it should be a trust. Now the mere fact that something is called a "unit trust" is not conclusive that it is a trust. An investment trust, for example, is not a trust at all. The "trusts" with which anti-trust legislation is concerned are cartels. It was a mere historical accident that the cartels at which nineteenth century US anti-trust legislation was principally aimed constituted trusts in the strict sense of the word. The term then became misused by lawyers who knew rather more about competition law - one hopes - than about Equity. The misuse has now become so widespread that it is impossible to say that it is wrong.

The second characteristic of a unit trust is that the trust property is held upon trust for the beneficiaries who are entitled thereto in fractional shares, termed "units". In particular, the trust property is not held upon trust for beneficiaries by way of succession or subject to contingencies. The beneficial limitations are in no way discretionary. There is no trust for or power of accumulation.[3]

These are the core characteristics of the unit trust. The deed of a unit trust may also contain special provisions regarding transmission of the rights of the beneficiaries, although such provisions are not essential, as the beneficiaries will always be able to deal with their interests in accordance with the rules of equity or any relevant statute.[4] As the purpose of a unit trust is usually collective investment, the trustees will normally have powers of sale and reinvestment of the trust property. They will in effect be investment managers in whom the legal title to the fund of investments will be vested.

A unit trust might be referred to as a "closed" unit trust. Most unit trusts are "open" in that the trustees are empowered to issue new units for a consideration which is added to the trust fund. Trustees often have power to redeem or buy back units, in which case the beneficiary is paid out his share of the trust fund, the value of which is determined by a formula, whereupon his interest in the trust fund is *pro tanto* extinguished.

Trustees are often given a discretion as to how much income, or other gains, they should distribute periodically to beneficiaries. In so far as the income of a beneficiary's share does not fall to be distributed and is retained by the trustees, it

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3 References in unit trust deeds to "accumulation" are best understood as references to retention by the trustees of income.

4 The relevant statute in England would be Law of Property Act 1925 section 53(1)(c).

is not "accumulated" in the strict legal sense of the word as the beneficiary is the only person who is entitled to it and sooner or later it must be paid to him (or his heirs or assigns). In my view, for United Kingdom tax purposes too, the beneficiary is in principle entitled to, and therefore taxable on, the income of his share even though the trust instrument provides that it shall be "accumulated".[5]

6 The Analysis

6.1 English Law Trusts

I shall assume for the time being that any relevant law applicable to the trust and the disposition of any interest therein is identical to English law. I consider at 7 how the analysis may differ where this is not the case.

Now the essence of a unit trust is that the beneficiaries are tenants in common in equity of the trust assets in which they have an equitable proprietary interest. See, for example, *Archer-Shee v Baker*.[6]

It is, of course, true that the beneficiaries have a right of action against the trustee to compel due performance of the trust. The crucial point is that they have much more than that. If the trustee gives away the assets to his girlfriend, she still holds them upon trust for the beneficiaries and they can assert their equitable proprietary interests against her. If she transfers the legal title to the assets to a *bona fide* purchaser without notice of the trust, then the beneficiaries can claim an equitable proprietary interest in the proceeds of sale.

6.2 An Example

Suppose Mr and Mrs A decide to set up a unit trust of which they are the only unit holders. The sole trustee is a corporation incorporated and resident in and only in the Cayman Islands. The proper law of the trust is that of the Cayman Islands.[7] The trustee invests the whole of the trust fund in UK quoted equities. Mr A dies and leaves the whole of his units to his daughter. Is there a charge to United Kingdom inheritance tax on the basis that Mr A's interest in the trust was situate in the United Kingdom and, therefore, does not constitute "excluded property"?

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5 I appreciate that UK tax law now contains its own code for taxing unit trusts which overrides the basic principle.

6 (1927) 11 TC 749 (HL).

7 I believe that the trust law of the Cayman Islands does not differ in any material particular from that of England.

On the one hand, it can be argued that as Mr A has an equitable proprietary interest in the equities and those equities are clearly situate in the United Kingdom, then his interest in the equities is equally situate in the United Kingdom. It could be argued on the other hand that as the equities are vested in the name of the trustee, the trustee is resident in the Cayman Islands and the courts of that jurisdiction are the proper forum for the administration of the trust, then Mr A's rights under the trust are situate only in the Cayman Islands and therefore do constitute excluded property.

6.3 *Re Clore Deceased*

A very similar point was considered by the English Court of Appeal in *Re Clore Deceased.*[8] Sir Charles Clore, the property magnate, emigrated from the United Kingdom shortly before his death with a view to establishing his domicile in Monaco.[9] He transferred certain real property in England into the name of Stype Investments Ltd, a Jersey incorporated and resident company, upon trust to sell the property and upon trust to hold the net proceeds of sale for himself. The question arose on Sir Charles' death as to where his rights under this trust were situate. It was argued on behalf of his executors that all he had was a right to enforce the trust against the trustee and that that right was situate in Jersey because that was where the trustee was and could be sued. The Court of Appeal held that what he had was an equitable proprietary interest in UK situate real property, which interest was situate in the UK. Templeman LJ brushed aside the arguments to contrary in his classic style. The case was too plain for argument. On this occasion, at least, my reaction is precisely the same as that of Lord Templeman. The trust property was situate in England and the English Courts would have entertained an action by Sir Charles to prevent a breach of trust. While the Royal Court of Jersey would, of course, have been *a* proper forum for administration of the trust, it did not follow that an English Court would not also be a proper forum. See *Chellaram v Chellaram.*[10]

6.4 Conclusion

In my view the UK Capital Taxes Office would have a good chance, in reliance on *Clore*, of taxing Mr A's estate on his death in the circumstances envisaged.

8 [1982] STC 625.

9 In later proceedings, it was held that he had never lost his English domicile. See *Re Clore Deceased (No 2)* [1984] STC 609. At this point in the proceedings, however, the contrary was being maintained.

10 [1985] 1 All ER 1043.

7 Non-English Proper Law Trusts

7.1 Different Result

If the proper law of the trust is not English, or akin to English law, then I agree that the situation might be very different. It was found in *Archer-Shee v Garland*, as a matter of fact on the evidence, that under the law of New York State a beneficiary under a trust has merely a personal right to require the trustee to account and does not have a proprietary interest in the trust assets. It would appear that the law of Scotland is the same. In such a case, the argument that the rights of the unit holder are situate where the trust property itself is situate is not a compelling one. The beneficiary has nothing more than a chose in action and the situs of that chose in action will depend on factors such as where it can be enforced, where the trustees are resident and/or established and, possibly, the proper law of the trust.

7.2 *Livingston*

In this context, the decision of the Privy Council in *Commissioner for Stamp Duty for New South Wales v Livingston*[11] would be very much in point. That case was discussed by Lord Browne-Wilkinson in *Marshall v Kerr* [1994] STC 638 at page 649:

> "In *Livingston* A died domiciled in New South Wales leaving one third of his residuary estate to B. The assets of the estate included land in Queensland. Whilst the estate was still being administered, B died also domiciled in New South Wales. The Queensland revenue authorities claimed death duties on B's death on the one third share of the land in Queensland to which B was entitled under A's will. The claim failed because B had no assets within Queensland. A's estate was still being administered and so long as such administration continued B (notwithstanding that she was entitled to one third of A's residuary estate) had no legal or equitable interest in the land in Queensland. Her sole right was to have A's estate duly administered. Lord Radcliffe, speaking of the 'trusts' on which personal representatives hold an unadministered estate said this (at 707–708):
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> > 'It may not be possible to state exhaustively what those trusts are at any one moment. Essentially, they are trusts to preserve the assets, to deal properly with them, and to apply them in a due course of administration for the benefit of those interested according to that course, creditors, the death duty authorities,

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11 [1965] AC 694.

legatees of various sorts, and the residuary beneficiaries. They might just as well have been termed "duties in respect of the 'assets' as trusts." What equity did not do was to recognise or create for residuary legatees a beneficial interest in the assets in the executor's hands during the course of administration. Conceivably, this could have been done, in the sense that the assets, whatever they might be from time to time, could have been treated as a present, though fluctuating, trust fund held for the benefit of all those interested in the estate according to the measure of their respective interests. But it was never done. It would have been a clumsy and unsatisfactory device from a practical point of view; and, indeed, it would have been in plain conflict with the basic conception of equity that to impose the fetters of a trust upon property, with the resulting creation of equitable interests in that property, there had to be specific subjects identifiable as the trust fund. An unadministered estate was incapable of satisfying this requirement. The assets as a whole were in the hands of the executor, his property; and until administration was complete no one was in a position to say what items of property would need to be realised for the purposes of that administration or of what the residue, when ascertained, would consist or what its value would be.'"

8 The Shipwright/Ghosh Argument

8.1 Units Analogous to Shares

The learned authors state under the heading "Units Analogous to Shares":

> "On the basis that the units are transferable, confer income rights when the scheme is ongoing and rights to money payments on redemption of the units or termination of the scheme and that the transfer of the assets held by the unit trust (via the intermediate company) in specie is usually at the discretion of the trustees and not a right of a unit holder, we conclude that the unit falls within the definition of "security" outlined by Ungoed-Thomas J in *IRC v Parker* (1964) 43[12] TC 396 at 408B: 'security by a document establishing personal liability and without a charge on property is recognised as a form of security.'
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> "The question then arises as to what is the situs of the unit. On the basis that it is registered and transferable via the register, the situs of the register, in our

12 RV's note: in the original, there is a printer's error and the wrong volume is given.

> view, determines the situs of the unit (*A V B Higgins* (1857) 2 H & M 339 and *Eire Beech Company Ltd v AG Ontario* [1925] AC 161 *Standard Chartered Bank Ltd v IRC* [1978] 1 WLR 1160). Assuming the register is kept offshore, the situs of the units follow the non-UK situs of the register."

The reader might at first blush think that the learned authors are stating that Ungoed-Thomas J in *Parker* was laying down a definition of "security", which they have quoted in full. The question in that case was whether debentures which evidenced a mere personal obligation of a company and which did not confer any charge over its assets were "securities" within the meaning of what was then Finance Act 1960 section 28, now Taxes Act 1988 section 703 (tax avoidance - cancellation of certain tax advantages from transactions in securities). Ungoed-Thomas J reviewed the authorities and concluded:

> "These cases indicate, to my mind, (1) that prima facie "security" is limited to security for the payment of a debt as contrasted with shares in the capital of a company; (2) that the context may extend its meaning to include shares; (3) that security by a document establishing personal liability and without charge on property is recognised as a form of security; (4) that it is questionable whether security in that sense would be within its prima facie meaning; but (5) even if it is not within the prima facie meaning of security, yet such security is a less extended meaning of that word than are shares."

When one reads this passage, one becomes convinced that what the learned authors meant is, not that the definition of "security" is "security by a document establishing personal liability and without a charge on property is recognised as a form of security" but that such a document is one type of security.

Parker was not itself concerned with the situs of any security. The traditional view is that the situs of a security might well depend on what sort of security it is, for example, whether it was a deed, and whether it gave a charge over or other proprietary interest in assets.

In any case, there is a crucial distinction to be made. If the rights of the unit holder constitute a merely personal right, with no proprietary interest in the assets of the trust, then I agree that the situs of those assets is irrelevant in determining the situs of his unit. The analysis at section 6 above, however, shows that this is not beyond doubt.

To what extent is it important that "the transfer of the assets held by the unit trust ... in specie is at the discretion of the trustees and not a right of a unit holder"? One rather gathers that if this is not the case - and, to my mind, it is not an essential part of the definition of a "unit trust" - then the learned authors would reserve their position. If it is the case, then, in my view, that sole fact does not, without more, alter the position. If the unit holder has a proprietary interest in the underlying assets, it is irrelevant that the trustees are in effect given power to purchase his interest for cash should he wish to redeem. If the true analysis, however, is that he never has a proprietary interest in the trust assets, then I agree that the position is very different.

Consider an extreme example. The terms of the "trust" are such that the trustees beneficially own all the "trust" property. Their only obligation to a unit holder is to pay him sums of money, the amount of which is fixed by reference to the value and income of the "trust" property. In that case, the unit holder clearly has no proprietary interest in the "trust" fund. In my view, however, there is not a unit trust at all, as there is not a trust of any kind. One might compare the personal portfolio insurance bond of the type discussed in *Willoughby v IRC*, where the policy holder has no proprietary interest in the assets of the linked fund, which belongs both legally and beneficially to the insurer. If one strips off such a policy whatever provision - usually almost token - there is for true life assurance, one has an arrangement very close indeed conceptually to that of the extreme case of "unit trust". Indeed, if the quasi-insurance bond is linked to a common fund and not to a personal fund, the two become for all practical purposes indistinguishable.

If the situs of the unit is not the situs of the underlying assets, then the question would arise where it is situate. I agree that if it is capable of being transferred *only* via the register, then it very probably will be situate where the register is kept. If, however, it is transferable via the register but also by other means, then it is a much more open question.

8.2 Units Analogous to Partnership Share

Under this heading, the learned authors state:

> "In the absence of a separate personality on the part of the unit trust, the rights of the investors in respect of their units may give rise to the argument that the unit holder's rights are more analogous to that of a partner's share in a partnership rather than that of a shareholder in a company. We are not attracted by this argument. The title to the underlying assets is, in the type of unit trust we examine, in the name of the trustee. Management of the underlying assets is in the hands of the management trustee. The relationship amongst the unit holder, the trustee and management trustee is not one of carrying on business in common with a view to making a profit, (see s.1(i) of the Partnership Act 1890) since the unit holder is merely a passive investor. Thus the relationship is not, in UK terms, properly viewed as one of partnership.

> "In any event, for present purposes the distinction between the unit as security and the unit as partnership share is largely academic. A partnership share is a separate item of property which gives income and capital rights but no interest in the specific underlying assets in English law. The location of a partnership share is the territory in which that partnership business is carried on, (*in the Goods of Ewing*; (1881) 6 PD 23 *Laidkey v Lord Advocate* [1890] 15 AC 468; *Beaver v Master in Equity of Victoria* [1895] AC 251 (PC); *Commissioner of Stamp Duties v Salting* [1907] AC 449 (PC)) which would in the circumstances we consider, be the territory where the trustee and management trustee carry on business."

While I agree with them that a unit trust is not a partnership, it just might be possible to argue that the rights of a unit holder under a unit trust are analogous to those of a partner in an English style partnership. Ar first blush, the two would appear to have little in common where the unit holder does have a proprietary interest in the trust assets. Yet the statement "A partnership share is a separate item of property which gives income and capital rights but no interest in the specific underlying assets in English law", is potentially misleading, as was shown by the recent decision of the Court of Appeal in Memec plc v Commissioners of Inland Revenue [1998] STC 754. As Peter Gibson LJ said, at page 763:

> "The relevant characteristics of an ordinary English partnership are these: ... (5) the partners own the business, having a beneficial interest, in the form of an undivided share in the partnership assets (see *MacKinlay (Inspector of Taxes) v Arthur Young McClelland Moores & Co* [1989] STC 898 at 900, [1990] 2 AC 239 at 249 per Lord Oliver), including any profits of the business."

8.3 Rights in Units Similar to Beneficiaries' Rights in Trust Fund - Right Analogous to Creditors' Right

Under this heading, the learned authors state:

> "What if one were to "look through" the units? Our conclusion as to situs does not change. To our mind, the only alternative analysis to that given above, whereby we reached the conclusion that the property comprised in the estate of the unit holder for IHT purposes was the units rather than any proprietorial interest in the trust fund, is that the unit holder has a beneficiary's interest in the common fund. Certainly the beneficiary has an "in personam right to compel the trustees to perform the trust" but equitable rights in rem against third parties "as a result of equitable tracing rights" (see Hayton & Marshall, *Cases and Commentary on the Law of Trusts* p 11).

"What is the nature of this interest? Assuming that the investor-beneficiaries' rights are analogous to those of beneficiaries in English law (and this would be a question of interpreting the domestic law which was the proper law governing the unit trust) the units would give personal rights enforceable against the trustees by reference to the proper law governing the common fund. On this basis, bearing in mind that the proper law of the trust is non UK, the in personam right against the trustees does not have a UK situs. So far as any rights in rem are concerned, these are clearly determined by the trust deed. We have already noted above that generally the trust deeds governing non-UK unit trusts provide for a single common fund in which the unit confers no interest or any share in any particular part of the assets comprising that common fund. It follows that the unit holder can have no more than a monetary right to an undivided share in the fund, irrespective of whether this right is proprietorial in nature or not. There is no right in rem vis a vis the trustees in respect of the underlying assets.

"Thus we see that the ongoing right of a unit holder under the type of scheme considered here is (during the life of the scheme) only to cash and not to specific assets or any part of the fund. This arrangement is analogous to a debt whose situs is where it can be enforced, which would be where the trustees are resident (see *English, Scottish and Australia Bank Ltd v IRC* [1932] AC 238 and *New York Life Insurance v Public Trustee* [1924] 2 Ch 101). It follows that, on the view that the units in the type of non-UK resident unit trust we consider give rights analogous to the share of a beneficiary in a non-interest-in-possession trust, the rights in respect of such units are effectively creditors' rights. It further follows that on this view there is no UK situs asset for the individual who holds units in a non-UK unit trust and has no UK domicile.

"It is true to say that the unit holders, in their entirety acting together, may perhaps in terms of the proper law governing a particular unit trust, terminate the scheme on a *Saunders v Vautier* basis, thus giving these unit holders an equitable proprietorial right in the fund, rather than merely to cash, and the fund may, as we have observed, include shares in UK resident companies. However, an individual unit holder (whose rights are determined by the proper law of the settlement: *Duke of Marlborough v AG* [1945] Ch 78) quite simply does not have such a right. The position is no different in respect of individual beneficiaries of a discretionary trust. The right to terminate a trust by acting together with all of the other interested parties does not confer a UK situs on the rights held by an individual beneficiary simply by reason of the trust fund containing UK situate assets.

"Furthermore, the very fact that whether or not all of the investors could

> terminate the arrangement is a matter of the proper law governing the trust again suggests a non-UK situs in respect of the rights held by each individual unit holder."

If the unit holders do indeed have "equitable rights in rem against third parties", then it could be argued that that is a vital point of distinction and that that proprietary interest, good against not only the trustees but the whole world (unless and until it is defeated), is more potent in determining the situs of the unit than is the personal right which the unit holder undoubtedly has against the trustees.[13] The *Archer-Shee* cases[14] could be cited by way of analogy.

If the unit does indeed "confer ... no interest or any share in any particular part of the assets comprising that common fund", then I agree that the conclusion follows that "the unit holder can have no more than a monetary right". Maybe I am just a stuffy Lincoln's Inn trust lawyer whose mind is not flexible enough to consider types of trust I do not often encounter, yet I find the concept of "a monetary right to an undivided share in the fund, irrespective of whether this right is proprietorial in nature or not" to be a difficult one to digest. To my mind, if there is no money, simply assets which might be turned into money, then any claim the unit holder has to receive money must necessarily be personal and not proprietorial.[15]

The mere fact that under the unit trust deed the unit holder does not have the right to withdraw his share of the trust assets in specie does not, of course, mean that he has "no interest or ... share in any particular part of the assets comprising that common fund". If, for example, the trustees of a Cayman Island unit trust the only asset of which was shares in an English holding company were to give them away to charity, then the unit holder would in my view, unless the trust instrument otherwise provided or the law of the Cayman Islands differed from English law in this respect, have an action in the English courts to secure their recovery. This could only be by virtue of a proprietary interest.

8 Conclusion

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13 Whether that right is situate in the jurisdiction of the proper law of the trust, as the learned authors suggest, or elsewhere, e.g. the place where they reside, is a further difficult point.

14 See 6.1 and 7.1 above.

15 I also have difficulty in accepting, at least in the matter of a trust governed by English law, that "the share of a beneficiary in a non-interest-in-possession trust" is "effectively [a] creditor's right".

Where the proper law of a unit trust does not differ in any significant respect from English law, then there is a risk that the rights of the unit holders would be held, at least by an English court, to be situate where the underlying trust property is situate. It would be possible in principle to alter the position by appropriate drafting of the trust instrument. The point could, however, be reached where there was not a unit trust because there was not a trust at all. This could have other consequences.