The Offshore Tax Planning Review

CAPITAL DISTRIBUTIONS FROM NON-RESIDENT TRUSTS: A TAX TRAP FOR CHARITIES

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1 The Background

The United Kingdom Offshore Beneficiary Provisions, contained in Taxation of Chargeable Gains Act 1992 ("TCGA"), sections 87-96A, can affect non-United Kingdom resident trusts of which the settlor is domiciled and resident or ordinarily resident in the United Kingdom at a material time.[2] They operate by imputing chargeable gains to persons who receive "capital payments" from the trustees. The gain imputed cannot exceed the value of the capital payment received. Nor can total gains imputed to recipients of capital payments exceed total chargeable gains realised by the trustees.

Suppose that:

> a UK charity receives a capital payment from the trustees of a settlement to which the Offshore Beneficiary Provisions apply;
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> the trustees had realised chargeable gains;
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> if the charity were an individual domiciled or resident in the United Kingdom, a chargeable gain would be imputed to it and it would be liable to capital gains tax accordingly; and
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> the charity applies the capital payment for charitable purposes only.

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2 The Provisions are fully discussed in my *Non-Resident Trusts* 6th Edition Chapter 14, published by Key Haven Publications Plc.

Will the charity be liable to tax?

2 The Revenue's View

I must confess that until recently it would never have occurred to me that the law could be so absurd as to render the charity taxable. Even if it did, I would confidently have predicted that, given the general tenderness of the Revenue to *bona fide* charities, they would never take so technical and unmeritorious a point. I would have been completely wrong. Nor is the stance being taken simply that of some aberrant Inspector. It is the considered view of both the Trusts & Settlements and Charities Sections of FICO at Bootle. Exemption is denied because:

> "the subject of charge [under TCGA 1992 section 87(4)] is an amount of notional trust gains. The capital payment made by the trustees merely identifies the beneficiary to be charged and sets a limit on that charge. Accordingly, as the beneficiaries are assessed on something purely notional which, by definition, cannot be "...applicable and applied for charitable purposes", the wording of section 256(1) is not satisfied."

3 Common Sense

This result is certainly paradoxical. If one steps back for one moment from the morass of technicality, one sees that the result is in accordance with neither common justice nor commonsense. What is the purpose of section 87? It is an anti-avoidance provision. What is the avoidance which needs to be counteracted? The trustees of the non-United Kingdom resident trust are not themselves normally liable to UK capital gains tax in respect of chargeable gains realised by them, notwithstanding that those gains may enure for the benefit of beneficiaries who are domiciled, resident and ordinarily resident in the United Kingdom. Section 87 therefore operates by ensuring that chargeable gains in reality realised by the trustees are imputed to beneficiaries. The mechanism is a little crude in that it operates the FIFO basis, which is favourable to the Revenue in terms of timing. At the end of the day, however, the provisions by and large work fairly. Ultimately, the entire trust fund must be distributed to beneficiaries. All the gains realised by the trustees will, except to the extent to which they have been reduced by losses, be imputed to beneficiaries and those beneficiaries who are within the charge to capital gains tax by virtue of being both domiciled and resident or ordinarily resident in the United Kingdom will in principle be liable to tax thereon.

Now, a charity is not liable to capital gains tax on capital gains realised by it, provided the capital gain is applied for charitable purposes only. Provided, therefore, the capital payment received by the charity from the non-United Kingdom resident trustees is itself applied for charitable purposes only, there would have been no avoidance of tax and no reason at all why the charity should be chargeable under the Offshore Beneficiary Provisions.

4 The Offshore Beneficiary Provisions

Let us consider the relevant provisions in the Taxation of Chargeable Gains Act. The side note to section 87 is "Attribution of gains to beneficiaries". Section 87(4) provides:

> "Subject to the following provisions of this section, the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year."

It is true that the chargeable gains which are imputed to recipient beneficiaries are gains "in gross", that is they are not deemed to be gains arising from the disposal of any particular asset. Nor is the recipient beneficiary deemed to own the asset. This feature can work against the Revenue in certain contexts. For example, a recipient beneficiary who is resident in the United Kingdom for the purposes of domestic law may nevertheless be resident in the jurisdiction of another Contracting State with which the United Kingdom has a double taxation convention. In that case, the beneficiary may be exempt from capital gains tax on capital gains except insofar as they arise from the disposal of particular assets, such as land situate in the UK. Because the gain imputed to a beneficiary under section 87(4) is a gain in gross, it will not fall within any of the specific exceptions to the rule which allow the UK to tax the beneficiary. Instead, the beneficiary will be able to take advantage of the basic rule which will normally apply to all gains not otherwise specifically dealt with in the relevant article.[3]

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[3] For the use of double taxation treaties in capital gains tax planning, see my *Capital Gains Tax Planning for Non-UK Residents*, published by Key Haven Publications PLC, especially Chapters 5 and 6.

5 The Charitable Exemption

The exemption for charities is contained in section 256. It provides that, subject to certain exceptions, "a gain shall not be a chargeable gain if it accrues to a charity and is applicable and applied for charitable purposes". What is the relevance of a gain not being a "chargeable gain"? A person can be liable to capital gains tax only in respect of "chargeable gains": see section 1(1) and section 2(1). What is a chargeable gain? Section 15(2) provides: "Every gain shall, except as otherwise expressly provided, be a chargeable gain."[4] The draughtsman of the Act often confers an exemption from tax by providing that a gain shall not be a chargeable gain. For example, the principal residence relief is conferred by section 223(1) which provides "no part of a gain to which section 222 applies shall be a chargeable gain if...".

At first blush, there appears to be a head-on conflict between section 87(4) and section 256(1). Section 87(4) deems a chargeable gain to have accrued to the charity whereas section 256(1) deems a gain accruing to a charity not to be a chargeable gain, subject to its being applicable and applied for charitable purposes. I see no difficulty whatsoever in resolving the conflict. Section 87(4) is a general rule which applies to all beneficiaries, whereas section 256(1) is a specific rule which applies to charities. On the principle *generalia specialibus non derogant*, section 256(1) prevails. Section 256(1) is only needed where a gain accruing to a charity is, section 256(1) apart, a chargeable gain.

Nor can any argument to the contrary be placed upon the wording of section 87(4), namely that chargeable gains are to be treated as accruing to beneficiaries. Had section 87(4) simply treated "gains" as accruing to beneficiaries, then it is arguable that the Provisions would have failed to bite. For while section 15(2) provides that every gain is, except as otherwise expressly provided, to be a chargeable gain, section 15(1) refers to "the amount of the gains accruing on the disposal of assets". Hence, it would be highly arguable that section 15(2) applies only to a gain on the disposal of an asset and, *ex hypothesi*, the recipient beneficiary will not have disposed of any asset: nor is he deemed to have done so.

It should be noted that there is nothing in section 256(1) to make the charitable exemption depend upon the charity having disposed of any asset. All that is necessary is that a chargeable gain "accrues" to a charity. There can be no doubt whatsoever that where section 87(4) applies, then its effect is to make a chargeable gain "accrue" to a charity.

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4 The converse is not true. The mere fact that a person realises a chargeable gain does not mean that he is liable to tax.

6 Application for Charitable Purposes Only

The Revenue do not seem, at least at this stage, to be in disagreement with my reasoning so far. Instead, their argument rests upon the fact that a gain deemed to have accrued by section 87(4) cannot be applicable and applied for charitable purposes only, hence the closing words of section 256(1) are not satisfied. What is meant by this expression "applicable and applied for charitable purposes"? It is borrowed from the wording of the corresponding income tax exemption, which is of considerable antiquity.[5] See Taxes Act 1988, section 505. There has not, so far as I am aware, been any judicial discussion of what the expression means in the context of capital gains tax.

Now a capital gain is not an item of property. It is an arithmetical difference. In the simple case of a purchase and later sale of an asset, the gain is calculated by deducting from the proceeds of disposal the acquisition cost, indexation relief and certain costs of acquisition, disposal and enhancement of value. A capital gain cannot exist as a separate item of property in the same way that, say, can a dividend paid by a company to one of its shareholders. Now the concept of income or capital gains being applied for charitable purposes only has always been understood to be merely an accounting one. No one has ever suggested that in order for the exemption to be available the charity must be able to perform a tracing exercise and show that the very same money which was received as income has been applied for charitable purposes. Indeed, in the case of capital gains and in the case of any form of income which does not consist of payments representing pure income profit, this cannot be done precisely because the profit or gain is merely an arithmetical difference. It has always been considered sufficient that *an amount equal to* the profit or gains in question is applied for charitable purposes only.

No one has ever suggested the contrary because it would be arrant nonsense to insist that a charitable exemption should be dependant on the charity being able to perform a successful tracing exercise. In practice, a charity will usually have one bank account into which it will pay both "pure income profit", such as dividends, receipts to be taken into account in computing income and chargeable gains and other receipts. Likewise, from the account it will indiscriminately make payments which consist of items deductible in computing income or capital gains, expenditure for charitable purposes both of a capital and of an income nature and other miscellaneous expenditure.

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[5] See *Commissioners of Inland Revenue v Helen Slater Charitable Trust* [1981] STC 471.

Can it be seriously argued that if the Revenue can show[6] that a given item of income received by a charity was in fact expended by it in acquiring a capital asset, then, notwithstanding that an equal sum in fact traceable to a legacy was applied by the charity for its charitable purposes, the charitable exemption in respect of the income is not to apply?

Once one understands that the requirement that a capital gain be applied for charitable purposes only involves only an accounting exercise and not a tracing exercise, then the last vestments of credibility fall off the Revenue's argument, which is exposed as a mere phantom having no firmer foundation in technicality than it has in reason or commonsense. For, *ex hypothesi*, the capital payment received by the charity can never be greater than the chargeable gains attributed to it by virtue of its receipt. Hence, provided the payment is applied for charitable purposes only, it will always have so applied a sum at least equal to any gain so attributed.

7 Charitable Trusts and Charitable Companies

Are charitable trusts and companies different? I would not for one moment agree that chargeable gains can be imputed to a charitable *trust* under section 87(4). In my view, which has been fully set our in successive editions of my *Non-Resident Trusts*,[7] section 87(4) has no application where property is transferred from a settlement to another settlement. Every charitable trust will constitute a "settlement" for this purpose. This is presupposed by TCGA section 90 (Transfers between settlements). If I am wrong, the legislation becomes completely unworkable. I know my view to be shared by other Silks who practise in this area. I have not come across anyone who holds a view to the contrary. In fairness to the Revenue, in giving the ruling quoted above, their mind was not directed to the point, as the persons seeking the ruling simply assumed that section 87(4) did apply to charitable trusts.

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[6] e.g., by applying the rule in *Clayton's* case,

[7] See sixth edition at 14.11.2, 14.13.3, 14.15.8.3, 14.16.6 and 14.19.