The Offshore Tax Planning Review

INTERESTS IN OFFSHORE FUNDS HELD BY NON-UNITED KINGDOM RESIDENT TRUSTEES: FINANCE ACT 1995 CHANGES[1]

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1 Overview

United Kingdom Taxes Act 1988 Part XVII Chapter V charges gains arising from the disposal of a "material interest" in a "non-qualifying offshore fund" to income tax, rather than capital gains tax.[2] There is no indexation relief. While Finance Act 1995 amendments have reduced the scope of the provisions by redefining "offshore fund" more narrowly, they can still bite with a vengeance. In this article, I discuss the new definition and the peculiar way in which the provisions operate in relation to non-UK resident trustees, their beneficiaries and even, in some cases, third parties. I also examine the remaining scope for tax planning.

2 What is an "Offshore Fund"?

2.1 Present Law

The term "offshore fund" formerly embraced all unit trusts and companies resident outside the UK or established under foreign law. After the Finance Act 1995 amendments, it is now[3] limited to "collective investment schemes",[4] whether they are constituted by a company resident outside the United Kingdom, by a unit trust scheme the trustees of which are not resident in the United Kingdom or any other

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1 This article is based on material taken from the sixth edition of my *Non-Resident Trusts*, published by Key Haven Publications PLC autumn 1995. References to "NRT" in this article are to the sixth edition.

2 See s.757(1).

3 As from 29th November 1994.

4 As defined by Financial Services Act 1986.

arrangements which take effect by virtue of the law of a territory outside the United Kingdom and which under that law create rights in the nature of co-ownership. Hence, Chapter V will now apply in general only to the "roll-up funds" at which it was originally aimed.

2.2 The Former Law

Before the Finance Act 1995 amendments, non-resident trusts were most likely to fall foul of this provision where they invested in foreign closely held companies. Where the company was wholly owned by the trust, the trustees' interest would not normally have been a "material interest",[5] so that the Chapter would not apply. At the other extreme, where the trustees had less than a controlling holding but could sell their holding only for a price reflecting the fact that it was a minority holding and not for a price based on asset value, the interest would likewise not normally have qualified as a "material interest": see s.759(3). Dangers arose where the trustees were participators in a close company in the nature of a quasi-partnership where there were arrangements enabling the trustees to realise a price for their holding based on asset value.

3 Income Tax Charge on Beneficiary

3.1 The Basic Rule

If trustees dispose of a material interest in a non-qualifying offshore fund, then the capital gain, calculated without indexation relief, is deemed to be notional income. While the trustees themselves will not, by virtue of their non-UK residence, be liable to income tax on this notional income, it can be treated as income payable to them for the purposes of the income tax "transfers of assets abroad" anti-avoidance provisions.[6] It can also be taken into account so as to impute notional income to a beneficiary under the Offshore Beneficiary Provisions as applied, with adaptations, for this purpose.[7]

3.2 Gains of Offshore Companies

If such a gain arises to an offshore company owned by the trustees, the notional income of that company can be taken into account both for the purposes of the

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5 See s.759(8).

6 Contained in TA 1988 Part XVII Chapter III: see s.762(5).

7 See s.762(5) and s.762(2)-(4).

income tax anti-avoidance provisions[8] and for the purposes of the Offshore Beneficiary Provisions as applied for the purposes of the Offshore Funds legislation, in much the same way as if it were a normal capital gain.[9]

3.3 Double Taxation

Prima facie, an offshore income gain of non-United Kingdom resident trustees or companies can be taken into account for *both* the purposes of the income tax transfers of assets abroad anti-avoidance provisions *and* the adapted Offshore Beneficiary Provisions. The only exception is that the gain cannot be deemed to be income of any individual for the purposes of TA 1988 s.739 or s.740 if, by virtue of the capital gains tax provisions, it is treated as having accrued to any person resident or ordinarily resident in the UK.[10] The result is that, unlike in the case of normal capital gains, it is not possible to "wash" a gain by appointing capital to a person not resident or ordinarily resident in the UK.

If s.739 or s.740 operates so as to tax a UK ordinarily resident individual on an amount equal to that of the offshore income gain realised by the trustees, there appears to be nothing to prevent the same gain being also taken into account under the Offshore Beneficiary Provisions. This is probably an oversight on the part of the draughtsman and one would hope that the Revenue would not seek to charge tax twice over.

A less obvious injustice is that if a capital payment is made to a person who is neither resident nor ordinarily resident in the UK there will be attributed to him first an offshore income gain of the trustees rather than a normal capital gain. While the payment to him will not diminish the notional income which can be taken into account for the purposes of, say, s.740, it will also leave undiminished the amount of normal trust gains which can be imputed to other beneficiaries who receive capital payments from the trustees. Thus, where the trust fund is appointed out both to UK resident and non-resident beneficiaries, the UK beneficiaries could be unfairly taxed on a disproportionate part of the trustees' offshore income gains and normal capital gains.

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8 See s.762(5), which applies to any *person* resident or domiciled outside the United Kingdom.

9 Taxation of Chargeable Gains Act 1992 s.13(10).

10 See TA 1988 s.762(6).

3.4 Scope for Planning

3.4.1 Life Interest Trust

Where trustees do hold a material interest in an offshore income fund, there will normally be very little scope for tax planning. It has been suggested that one possibility is to create an interest in possession in the interest so that the gain will be washed on the death of the beneficiary. This is based on the view that, while there is no tax-free uplift in a material interest in a non-qualifying offshore fund on the death of a person absolutely entitled, there is such an uplift on the death of a tenant for life under a trust, whether or not UK resident.[11]

The normal rule is that there is a disposal for the purposes of the offshore funds legislation whenever there is a disposal for capital gains tax purposes.[12] There is, for capital gains tax purposes, no disposal on the death of a person of assets to which he was absolutely entitled: Taxation of Chargeable Gains Act 1992 s.62(1)(b). That rule is expressly reversed for the purposes of the offshore funds legislation by Taxes Act 1988 s.657(3).

In the case of assets held by the trustees of a trust in which there subsists a life interest in possession, there is on the death of the tenant for life, for capital gains tax purposes, a deemed disposal and reacquisition by the trustees of the trust assets, but no chargeable gain accrues on the disposal.[13] There is no express provision in the offshore funds legislation which deems there to be a disposal for the purposes of that legislation. Hence, it might be thought that there is no charge under the legislation in such a case, but there is a tax-free uplift in base cost.

The difficulty with this argument is that the relevant sections of the Taxation of Chargeable Gains Act 1992 expressly say that there is a deemed disposal. They then go on to say that "no chargeable gain shall accrue on" the "disposal". The charge to income tax under the offshore funds legislation is contained in Taxes Act 1988 s.761(1), which provides:

> "If a disposal to which this Chapter applies gives rise in accordance with section 758 or Schedule 28 to an offshore income gain, then, subject to the provisions of this section the amount of that gain shall be treated for all the purposes of the Tax Acts as ... income ..."

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11 Inheritance tax considerations would also have to be borne in mind.

12 Taxes Act 1988 s.757(2).

13 See Taxation of Chargeable Gains Act 1992 s.72(1) (discussed at NRT 11.5.2) in the case where the trust assets continue to be settled property, and s.71 and s.73(1) (discussed at NRT 11.5.3) where they do not.

Taxes Act 1988 Sch 28 para 5 provides that, subject to an immaterial exception, a material disposal gives rise to an offshore income gain of an amount equal to the "unindexed gain" on that disposal. Subject to immaterial exceptions, the "unindexed gain" accruing on a material disposal is the amount which would be "the gain" on that disposal for the purposes of the Taxation of Chargeable Gains Act 1992 if it were computed on certain immaterial hypotheses: see para 2(2).

Now, on the death of a tenant for life under a trust, the trustees are deemed to dispose of the trust assets but no "chargeable gain" is to accrue on the disposal. Is it possible for the Revenue to argue that there is a "gain" for the purposes of the Taxation of Chargeable Gains Act 1992 even though it is not a "chargeable gain"? Prima facie, it is, as the two concepts are different. Taxation of Chargeable Gains Act 1992 s.15(2) provides that every gain shall, except as otherwise expressly provided, be a chargeable gain. Section 223(1), for example, provides that no gain to which s.222 (relief on disposal of private residence) applies shall be a chargeable gain.

Against this, one can argue that as para 2(2) refers to "the gain .. for the purposes of the [1992] Act if it were computed ...", "the gain" must refer to "the chargeable gain", as it is never necessary to compute for the purposes of the 1992 Act a gain which is not a chargeable gain.

Then again, para 3(1) provides "If the amount of any *chargeable gain*[14] ... which ... would accrue on the material disposal would fall to be determined in a way which ... would take account of the indexation allowance on an earlier disposal ... [which was a disposal on a no gain/no loss basis] ..., the unindexed gain on the material disposal shall be computed as if ... no indexation allowance had been available on any such earlier disposal ..." This, it could be argued, presupposes that "the gain" in para 2(2) means "the chargeable gain".

In summary, it is by no means clear whether offshore income gains of trustees are washed on the death of the tenant for life.

3.4.2 Washing of Gains by Appointments

There is some scope for "washing" a gain so far as s.740 is concerned by making an appointment to a beneficiary not chargeable under s.740. While the scope is somewhat greater than in the case of actual relevant income caught by s.740, it is not so great as in the case of general capital gains which are caught only by the Offshore Beneficiary Provisions.

Another possibility is to make an appointment to a beneficiary who is chargeable under s.740 but at a lower rate than might otherwise be the case. While such an

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[14] Italics supplied.

appointment would prevent the gain being taken into account again for the purpose of s.740 (or s.739) it would not in strict law "wash" it for the purposes of the Offshore Beneficiary Provisions.[15]

Where s.739(3) applies to a non-resident trust on the grounds that the settlor or his spouse has "power to enjoy" income arising within the trust structure, there is some doubt as to whether it is possible to "wash" the notional income as regards the s.739(2) charge by appointing it out to UK resident or ordinarily resident persons. This is because s.739(2) deems income to be that of the settlor as it arises, whereas the imputation of offshore income gains under the Offshore Beneficiary Provisions is an exercise which cannot be performed until the end of the year of assessment. If this fear is justified, then s.762(6) could not prevent a s.739(2) charge, based on "power to enjoy", but only one under s.793(3), based on receipt of a "capital payment" in a year following that in which the gain had already been attributed to a UK resident or ordinarily resident individual.

4 Conclusion

The difficulties of avoiding income tax charges, possibly quite unjust ones, demonstrate the general inadvisability of trustees acquiring material interests in non-qualifying offshore funds.

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15 See 3.3.