THE OFFSHORE SETTLOR PROVISIONS ADDITIONS TO NON-QUALIFYING SETTLEMENTS

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1 The Problem

In order for a settlement to be caught by the CGT Offshore Settlor Provisions,[2] it must be a "qualifying settlement". All settlements created after 18th March 1991 are qualifying settlements. Settlements created before that date only become qualifying settlements if a trigger event happens. The trigger condition which is giving rise to the most problems is the first - addition to the settled property. The relevant provision was altered during the passage of the Finance Bill.[3] The alteration raises as many problems as it solved.

FA 1991 sch 16 para 11(3) provides:

> "(3) The first condition[4] is that on or after 19th March 1991 property or income is provided either directly or indirectly for the purposes of the settlement -
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> (a) otherwise than under a transaction entered into at arm's length, and
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> (b) otherwise than in pursuance of a liability incurred by any person before that date;
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> *but if the settlement's expenses relating to administration and taxation for a year of assessment exceed its income for the year, property or income provided towards meeting those expenses shall be ignored for the purposes*

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[2] contained in FA 1991 sch 16.

[3] after I had written my article on them in the third issue of the first volume of this Review.

[4] i.e., trigger condition.

of this condition if the value of the property or income so provided does not exceed the difference between the amount of those expenses and the amount of the settlement's income for the year."[5]

2 The Need for Care

This trigger condition is clearly aimed at settlors who top up existing non-qualifying settlements. Yet its precise ambit is far from certain. Where it applies, the whole of the settled property is tainted, not merely the added property. Settlors will need to be very careful indeed.

3 Payment by Settlor of Trust Expenses

Some non-UK resident trusts own shares in English private companies which produce no income. The settlor may therefore each year pay out of his own resources the trustees' remuneration and other expenses. The words in italics were added to the FB at a late stage. But for them, any such payment would clearly have satisfied the first trigger condition as it would have been otherwise than by way of bargain made at arm's length and not in pursuance of a pre-19th March 1991 obligation.

The italicised exception is discussed at 6 below. Where it is not available, it may well be feasible to implement an alternative strategy which will enable the settlor to finance trust expenses without making an addition to the settlement.

4 Value-Shifting

The first trigger condition is that "property or income is provided either directly or indirectly for the purposes of the settlement". It is a moot point whether these words, wide as they are, are wide enough to catch value-shifting exercises. For example, suppose the trustees of a non-qualifying settlement purchase, on an arm's length basis, shares in a company. The shares are of little value but will become of enormous value if the settlor, who is also a shareholder, omits to exercise certain rights. He does indeed omit to exercise such rights. The trust's shareholding therefore rises enormously in value. The settlor has not literally provided property or income. He has added value to the settlement, but that is quite a different thing. One of the ways of adding value is to provide property or income. Yet that is not the only way. Were one back in the 1970's, such a strategy would probably have worked. Its effectiveness is obviously more questionable in the modern judicial climate.

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[5] My italics.

5 Transfers by Connected Persons on Arms' Length Basis

If a person connected with the trustees of a settlement makes a transfer of an asset to the trustees on an arm's length basis the first trigger condition will clearly not be satisfied. Yet I have heard an argument that it will.

The argument would apply to every sale of an asset to the trust. It would apply to a loan made to the trust or the purchase of an asset from the trust only to the extent that the payment made by the settlor was not in sterling.[6]

The argument appears to be as follows

"A CGTA s.62 applies where a person acquires an asset and another person disposes of it and the two are connected persons.[7]

"B The settlor of a settlement and the trustees of the settlement are connected persons.[8]

"C Where a settlor transfers an asset to the trustees of his settlement, the settlor and the trustees are treated as parties to a transaction otherwise than by way of bargain at arm's length.[9]

"D Para 11(3) applies where property or income is provided directly or indirectly for the purposes of a settlement otherwise than by way of bargain made at arms' length

"E Therefore, where a settlor transfers an asset to the trustees of his settlement, para 11(3) is inevitably brought into play."

The answer is that s.62(2) does not apply for *all* CGT purposes but *only* so as to bring s.29A into play and to deem the consideration for the disposal and the acquisition to be equal to market value. It is well established that deeming provisions in a statute are not to apply any further than is necessary for the purpose for which they are incorporated.[10]

Indeed, if the argument were correct it would prove far too much! Suppose a non-UK resident trust to which the Offshore Beneficiary Provisions apply sells for £100 an asset worth £100,000 to a beneficiary who is a connected person. If section 62(2) applied, the beneficiary would for the purposes of Finance Act 1981 s.83(4) be deemed to have given £100,000 for the asset. Hence the value of the capital payment

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6 Sterling cash is not an "asset" for capital gains tax purposes. See CGTA section 19(1). As will be seen, the argument applies only to "assets" for CGT purposes.

7 CGTA s.62(1).

8 CGTA s.63(3).

9 CGTA s.62(2).

10 See, for example, *Macpherson v IRC* [1987] STC 73.

made to him would be nil! The answer, of course, is that s.62 has only a limited scope and does not apply for the purposes of the Offshore Beneficiary Provisions.

A further reason why the first trigger condition is not satisfied is that even if the settlor is transferring an asset otherwise than by way of bargain at arm's length, he would not be providing "property or income for the purposes of the settlement". This phrase in my opinion clearly involves the motive of adding value to the settlement. When, for example, Midland Bank PLC makes a loan to trustees in the normal course of its banking activities, it does not provide property or income for the purposes of the settlement. It does so to earn its interest. If it did provide property or income for the purposes of the settlement it would thereby become a settlor for the purposes of the UK Settlor Provisions.[11] That would be clearly absurd. Similarly, it would be a settlor for the purposes of the Offshore Settlor Provisions, in that it would have provided property.[12] That would be equally clearly absurd.

In the original version of the FB, para 11(3)(a) read

> "(a) otherwise than *by way of bargain made* at arm's length ..."

The italicised words were replaced with "under a transaction entered into". While I can see no purpose for the change other than a desire to solve a non-existent problem, if there were a problem this would not be a solution. For if the settlor is for *all* CGT purposes deemed to provide property as a party to a transaction otherwise than by way of bargain made at arms' length, he must surely be deemed to provide it otherwise than under a transaction entered into at arm's length. For what on earth is a transaction entered into at arm's length which is not a bargain? Whoever heard of a gift at arm's length?

Perhaps all the change does is indicate that the Revenue are not particularly keen to take this dud point.

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[11] See FA 1988 sch 10 para 6(3).

[12] See FA 1991 sch 16 paras 9 and 10(1).

6 The Exception for Trust Expenses

The italicised[13] words in para 11(3) were added at a late stage in the passage of the Finance Bill. The intention was doubtless merely to allow settlors to pay the administrative expenses of "dry" trusts without prejudicing their protected status. They are a fine example of "Draft in haste; litigate at leisure."

Let us consider some of the ambiguities. Firstly, what are "expenses relating to administration and taxation"? "Taxation" clearly covers the paying of taxes but would cover other matters too, such as paying one's accountant to prepare computations and negotiate with the Revenue. The phrase might even arguably cover interest on money borrowed to pay taxes. Does "taxation" include tax other than tax on income? For example, capital gains tax, gift tax, wealth tax, estate duty, capital duty, stamp duty, real property tax or rates, sales tax or value added tax? Does it cover foreign taxes as well as UK taxes?

What is meant by "administration"? The expression "expenses of administration" does not look a difficult one on the surface, yet a similar expression, "expenses of management", has given rise to a surprising number of judicial authorities on its interpretation.

Are expenses relating to administration confined to expenses chargeable to income or which would be chargeable to income in the absence of any provision in the trust instrument? Compare the very different wording of TA 1988 s.686(2)(d) and the judgments of their Lordships in *Carver v Duncan* [1985] STC 356.

The exception applies only to property or income provided "towards meeting" those expenses. Suppose the property provided is exactly equal to and completely extinguishes the expenses. Can it be said that as the provision has done more than gone towards meeting the expenses - it has actually met them - then the exception does not apply?

The words "towards meeting" do seem to imply some purpose on the part of person providing the property or the income. If a small amount of property or income is provided generally but happens to be no greater than the amount of expenses, it would appear that the exception is not in point.

What is meant by "income"? Any competent draftsman should know that the meaning of this term in a taxing statute is wide open. It can mean simply income liable to UK IT. In the present context, I would have thought that most unlikely. It therefore has some more general, accountancy meaning. Normally, "income" does not mean receipts. Does it mean gross income or net income? Suppose, for example, the trustees of a trust carry on a trade. They incur expenditure partly for the purpose of the trade and partly for other administrative purposes of the trust. It is most unlikely that the gross receipts of the trade would be held to be "income" for the purposes of the exception. Yet what of the profits of the trade? Are they the income of the trust? Or is the income of the trust ascertained by deducting administrative expenses (chargeable to income) from the trading profits? If so, then the exception is very badly worded. Suppose that the trading profits are £2,000 and general administrative expenses are £1,500. If the income is only £500, then up to £1,000 can be provided towards meeting trust expenses without satisfying the first trigger

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[13] As set out in para 1 above.

condition.

Property or income provided is to be ignored if the value of "the property or income" does not exceed the difference between the amount of expenses and the amount of the settlement's income for the year. This is most odd. One would have expected the test to be that the total value of the property *and* income provided should not exceed the difference between the expenses and the income.

7 "For the Purposes of the Settlement" - *Mills v IRC*

I have mentioned above that in my opinion these words import a motive of adding value to the settlement.

It might be objected that there is a complicating factor in the shape of the decision of the House of Lords in *Mills v IRC* (1974) 49 TC 367, on ITA 1952 s.411(2),[14] which provided that a person was to be deemed to have made a "settlement" *inter alia* if he had provided or undertaken to provide funds directly or indirectly "for the purposes of the settlement". The Court of Appeal had held that in entering into a service agreement at a modest salary with a company owned by the trustees of a settlement made for her benefit by her father, the fourteen-year old Hayley Mills was not a settlor of any settlement as she had lacked the motivating intention of providing funds to benefit those interested under the trusts. The case was a special one in that her father made all the arrangements and she acquiesced without fully understanding or even caring. It appears to have been accepted that if she had made the arrangements personally she would have been a settlor.[15] The House of Lords clearly thought it was unjust that she should escape. Unfortunately, they gave inadequate reasons for finding against her. It was perhaps not surprising that the professional lawyers left it to Viscount Dilhorne[16] to give the only "reasoned" judgment. He rejected the view that "purpose" connotes a mental element or involves motivating intention! He merely said:[17]

> "Where it is shown that funds have been provided for a settlement a very strong inference is to be drawn that they were provided for that purpose, an inference which will be rebutted if it is established that they were provided for another purpose."

This is really most unsatisfactory. If A, having no gratuitous intent, makes a bad bargain with the trustees of a settlement, can it really be said that he has provided funds "for" a settlement, even if he has inadvertently added funds "to" a settlement. Could it really be said that Miss Mills had provided funds "for" the settlement? Does not the word "for" itself import purpose? Even if they have both provided funds "for" a settlement, A could no doubt on Viscount Dilhorne's test escape as he could show that he had some other motive, namely benefiting himself by a bargain made at arm's

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14 meaning of "settlement" for the IT settlement provisions: see now TA 1988 s.681(4).

15 See *Crossland v Hawkins* 39 TC 493.

16 who had come to the Lords via a career in politics.

17 at 408B

length. If the decision is still good law, it must be limited to the rare case where a person enters into a transaction which adds funds to a settlement without his having any motive at all.

It is doubtful whether the decision is still good law for income tax purposes. It was established by the House of Lords in *IRC v Plummer*[18] that for there to be a "settlement", there must be an element of bounty. If Miss Mills had no purpose at all, she cannot have had any gratuitous intent. Moreover, even if she had entered into the transaction with tax avoidance in mind, there would have been no bounty. The gifts under the settlement in favour of third parties which would have taken effect had she not survived to twenty-five were inserted simply in order to ensure that there was a trust, which was essential if she was to avoid surtax!

The CGT test of settlement is not the same as that in the IT settlement provisions[19]. It does not require any element of bounty. It is therefore possible that while *Mills* has been impliedly overruled for IT purposes, it is still valid for CGT purposes.

8 Funds v Services

For the first trigger condition to be satisfied, the settlor must provide "property or income". Suppose that he merely provides services. For example, suppose a settlor who is a successful property developer gives free advice to the trustees about a piece of land which they then buy, using existing funds, and which rises considerably in value. Does the settlement thereby become a "qualifying" settlement? Prima facie, one would have thought not. Yet there is still the House of Lords decision in *Mills* to contend with.

In the Court of Appeal, Buckley LJ had pointed out that on the Crown's contentions, a stockbroker might, if the advice he gave to the trustees of a settlement proved well founded, be said to be contributing to the settlement. In the House of Lords, Viscount Dilhorne dealt with this as follows:[20]

> "The difference between those cases ... and this case ... is that in ... this case funds which ordinarily would have been received by ... Miss Mills for [her] acting were diverted to [a company] which [was a channel] for their transmission to trustees. It is not the provision of services but of funds which comes within the section."

The final aphorism, despite its fine ring, is fundamentally misconceived. There is no antithesis between services and funds. Miss Mills provided funds by providing services. That is exactly what the stockbroker does. If there is a reason why he is not a settlor, it must be found elsewhere.

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18 [1979] STC 793

19 Now TA 1988 Part XV.

20 at 408D