"BAILING-OUT" OVERSEAS SETTLEMENTS: THE PITFALLS OF LENDING A HAND: FINANCE ACT 1991 Sch 16 Para 11(3)

Giles Goodfellow, Barrister[1]

Introduction

Following the changes made by the Finance Act 1991 Schedule 16, it is of critical importance to prevent an existing non-UK resident settlement for the benefit of a UK resident settlor or his children, becoming a "qualifying settlement". If such a settlement becomes a "qualifying settlement", chargeable gains arising to the overseas trustees for that, and subsequent, years of assessment will be chargeable on the UK resident settlor for the year in which they accrue.

Original Provisions of the Finance Bill 1991

Under the original provisions of the Finance Bill, a settlement created and resident outside the United Kingdom before March 19th 1991 would become a "qualifying settlement" if, on or after that date, property or income were provided for the purposes of the settlement. This understandable restriction on additional funding of existing settlements would have put many existing settlements into difficulties as regards their day to day running expenses: the principal assets of such settlements were commonly shareholdings in private companies or other assets yielding little or no income. These assets had been settled in the hope of deferring the chargeable gain on some future disposal. However, pending that glorious day, the income was unlikely to be sufficient to meet the charges of the professional trustees and other expenses connected with retaining the settlement's overseas status. But, under the proposed legislation, the assets of the settlement could not be "topped-up" to meet this shortfall without prejudicing the whole tax-deferral exercise.

1 Giles Goodfellow, 4 Pump Court, Temple, London EC4Y 7AN
Tel: (071) 583 9770 Fax: (071) 353 6366

Amendment of Schedule 16 Paragraph 11(3)

One might have expected the Inland Revenue to shed few tears over the plight of such settlements. It was, therefore, something of a surprise when late in the progress of the Finance Bill through Parliament, a measure was introduced to alleviate this perceived injustice. Paragraph 11(3) was amended so as to provide that:

> "... 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 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".

This amendment opens the door for the settlor and others to supplement the settlement to meet any shortfall between income and expenses. However, even though the legislative purpose behind this amendment may have been generous, the drafting is such that reliance on it will involve many settlements in considerable uncertainty and compliance costs.

Consequences of a Mistake

The first point to note is the importance of getting your sums right. If the value of the "income or property" contributed exceeds the shortfall as calculated above by even a small amount, then the whole of the settlement will become a "qualifying settlement" and not merely the assets held by the settlement which represent the excess contribution. Given the serious consequences of non-compliance, one would have hoped for a clear indication as to what items should or should not be included in the calculations below. Unfortunately, as will be seen, the provision is a maze of complexity and ambiguity.

Year by Year Calculation

The provision clearly requires a calculation for each year of assessment of:

(a) "the settlement's expenses relating to administration and taxation ... "; and

(b) "the settlement's income for the year".

If and to the extent that the amount in (a) exceeds the amount in (b), additional property or income may be contributed "towards meeting these expenses".

Carry Back and Forward of Income

There is no provision for carrying items of income or expense backwards or forwards to different years of assessment. This rule is a mixed blessing for taxpayers: a large surplus of income for the year of assessment 1991/92 will not reduce the amount of the contribution which can be made to meet a shortfall in 1992/93 even though the income from 1991/92 is still available to meet the shortfall. On the other hand, if there is shortfall in 1992/93 for which no contribution is made, this unrelieved shortfall cannot be used to excuse a contribution in 1991/92 which exceeds the amount of the shortfall for that year even though the excess contribution for that year is less than the unrelieved shortfall for the following year.

In the absence of any carry back provision, it is particularly important that an item of income or expense should be attributed to the correct year of assessment. An excessive contribution (as exemplified in the preceding paragraph) could easily be made if, in calculating the amount of the shortfall, an item of expense has been wrongly deducted in the year of assessment in which it accrued rather than the year in which it was paid, or an item of income was not recognised until the year of receipt. On the other hand, the absence of any provision for averaging out fluctuations of income or expenses over several years of assessment offers scope for increasing the amount of additional income or property which can be properly contributed. Where possible, income should be attributed to years for which the expenses are low and vice versa. The shortfall for other years should be increased thereby.

Recognition Basis for Income and Expenses

The legislation gives no clear indication as to the appropriate basis for recognising income or expenses. Dealing with expenses first, an expense can be described equally well as "for" the year of assessment in which all conditions necessary for imposition of that liability are satisfied, as being "for" the year of assessment in which it is paid. In fact, the operation of a strict cash basis for calculating expenses would run counter to the whole scheme of the provision. The apparent purpose of the provision is to permit contributions to "meet" (i.e., discharge) expenses for a year where there is not enough income to pay them. If these expenses could not be taken into account until paid, it is difficult to see how one could ever have a shortfall.

Nevertheless, it might still be argued that an expense which accrues in one year of assessment but which is not payable until the next should not be counted until the later year. After all, if an item can be taken into account for a year of assessment before it is payable it can generate a shortfall for that year. Can it have been Parliament's intention to permit additional contributions to be made several months before the expenses have even become payable? For example, a capital gains tax charge which accrues in 1991/92 will not become payable until December 1st 1992. If this item is deductible for 1991/92 a contribution towards meeting this expense could be made on April 6th 1992. In the eight months before this contribution needs to be applied, it may itself generate additonal income. This additonal income is unlikely to infringe para 11(3) since, if the contribution is ignored for para 11(3) purposes, then so too must the income generated thereby.
On the receipts side, the appropriate basis of recognition will depend on the meaning given to the word "income". If "income" is to be construed as being any item which is or would be chargeable to UK income tax, it would be appropriate to attribute such item to the year of assessment in which the conditions for the charge are or would be satisfied even if the item is not received until a later year. Accordingly, if the trustees

were carrying on a trade the profits of which were computed on an earnings basis, such profits should be treated for para 11 purposes as income for the year in which they were earned rather than the year in which they were received. In the case of many items of income the difference between a cash and earnings basis of recognition will not be significant since the receipt of an item is a condition precedent to its chargeability, e.g., interest.

If, on the other hand, "income" is to be given a less technical meaning so as to include any item which would be treated as income for trust purposes, the arguments in favour of a cash basis are much stronger. Once one has moved away fom the fiscal definition of income, there is no longer a detailed code of rules requiring particular items to be attributed to particular years. In the absence of such rules, it would seem more consistent with the purpose of the calculation (which is to determine whether the settlement has more income than expenses for the year) not to take an item into account until it is available to the trustees to spend.

Whilst the ambiguities in the statutory language may permit a certain latitude as to which basis of recognition is used, the very least the trustees must achieve is a consistent application from year to year of the basis they have chosen. Changing from one basis to another is likely to lead to items of expense and income either falling out of account or being counted twice which would appear to be contrary to the whole mischief of the provision.

Normally, it will be appropriate to use the same basis of recognition for both income and expenses, particularly if the same item is likely to give rise both to a receipt and an expense. However, there is no obvious conflict between recognising income on a cash basis whilst deducting expenses for the year in which they become payable. In this context, it is understood that the Inland Revenue will accept the use of any established basis provided it is thereafter consistently applied.

Constituent Elements of each Calculation

The doubts raised over the correct basis of recognition are as nothing compared with the uncertainties as to which items should or not be included in calculating the settlement's "income for the year" and "the expenses relating to administration and taxation". It is particularly unfortunate that the draftsman did not define what he meant by "income". The trustees are left without any reliable guide whether they are to include the settlement's income as calculated for UK tax purposes or as calculated for trust purposes or some third amount resulting from a special calculation incorporating aspects of both trust and tax law.

Meaning of Income

Although there is likely to be a large area of overlap between what is income for trust and tax purposes, there will be cases where the distinction will be very material. For example, where the trustees hold shares in a company which then repurchases those shares, the proceeds of sale will normally be a capital receipt for trust purposes and so would not reduce any shortfall in that year if the trust definition of income were the relevant test. However, if the company is UK resident, the purchase price will be a qualifying distribution for income tax purposes and so should form part of the settlement's income for the year if taxable income is the relevant test. Similarly, where a UK resident company pays a dividend to an overseas settlement, a UK resident life tenant of that trust will be entitled to a credit against basic rate income tax on account of the ACT paid by the company. Accordingly, the amount of income to which the life tenant is deemed to be entitled is the aggregate of the dividend and the tax credit (TA 1988 s.20). It is arguable that this grossed-up amount should be the amount included in the settlement's income. On the other hand, unless the tax credit entitles the life tenant to a refund, the tax credit would not form part of the settlement's income for trust purposes.

The use of the word "income" in conjunction with year of assessment initially suggests that "income" is to be the settlement's taxable income for each year of assessment. This construction would at least offer a conceptually certain and easily verifiable test. But there are a number of difficulties facing such a construction: first, overseas settlements will commonly derive a large proportion of their income from non-UK sources. It is difficult to believe that trustees are to be permitted to deduct all their administration expenses including expenses incurred in generating such income without having to bring such income into account. Consistent with using the UK tax definition of income, this obvious loophole can be closed only if "income" is treated as including all items which are either chargeable to UK income tax or would be chargeable if received by a UK resident and domiciled person. However, the insertion of such words goes well beyond the permissible limits of construction particularly where, in a similar context, Parliament has used express words to enlarge the ordinary meaning of income. (cf. definition of "income arising under a settlement" for the purposes of Taxes Act 1988 Part XV see TA 1988 s.681.)

Secondly, the amount of income of the settlement which is or would be chargeable to UK tax for a year of assessment will often be very different from the amount of income which has accrued or been received by the settlement during the same year of assessment. This is because income tax is frequently chargeable by reference to basis periods other than the current year of assessment. The use of such basis periods will commonly lead to the same item of income being charged twice and other items not being charged at all: the clearest example of this is in the special commencement and discontinuance rules for Schedule D Case I and II income. Since it is the actual income received that will be available to meet trust expenses, it would be inappropriate to adopt a definition of income which would measure the amount of any shortfall by reference to notional amounts of income.

Alternatives to the UK Tax Definition of Income

If one abandons the fiscal definition of income and includes any item of an income nature received (or earned) by the settlement during the relevant year of assessment one can be assured that over several years no item will fall out of the calculation or be counted twice. However, how does one determine what is a receipt of an income nature? If the test is how the receipt is dealt with by each particular settlement the rules of the proper law of that settlement become relevant. Quite apart from the considerable time it would take both the trustees and the Inland Revenue to establish the true position under different jurisdictions all over the world, there would be a risk that many settlements would adopt proper laws tailored to limit the amount of receipts attributable to income.

Applying an English law test of what is income for trust purposes would prevent this kind of forum shopping and make the test easier for the Inland Revenue to supervise. However, there is little support in the statutory language for applying the rules of one particular country's trust law for determining what is a settlement's income if the settlement would not apply those rules when answering the same question itself.

If the settlement's proper law is not determinative and English law cannot be substituted, then the only alternative is to develop and apply a set of principles supposedly common to most if not all trust law jurisdictions. However, such a synthesis is too onerous and uncertain a task to be attempted by the trustees, the Inland Revenue and most importantly the Courts. On balance, the author's tentative conclusion is that the Courts are more likely to apply the rules of the settlement's proper law. However, in the case of a settlement with a foreign proper law, the rules of that jurisdiction will have to be proved. Otherwise, they will be presumed to be in accordance with the law of the forum. In most cases, the expense of establishing tests radically different from those applicable under English law will not be justified. Accordingly, English trust law principles are likely to achieve a form of de facto ascendancy.

Meaning of "Expenses Relating to Administration"

The position is only marginally better when considering what are " the settlement's expenses relating to administration and taxation for a year of assessment". The first point to note is that the provision is concerned with expenses of the settlement and not of the trustees. Thus, it will be no objection to a claim to include sums paid under a trustee remuneration clause that none of the trustees has become liable for such expenditure.

Administration is not defined. However, the making and reviewing of investments, maintaining trust property, quantifying and settling the liabilities of the trust fund, exercising (or considering the exercise of) any discretionary powers held by the trustees and preparing accounts and returns in respect of trust income and gains would all appear to constitute acts of administration. The category of deductible items is not limited to expenses incurred in the direct performance of these tasks. Expenses are deductible if they relate to administration. Accordingly, there should be little problem in deducting fees paid to third parties for advice given concerning the propriety of proposed acts of administration. Likewise, reasonable fees charged by trustees for time spent in performing various acts of administration should be deductible provided they are authorised by the trust instrument.

Are Only Income Expenses Deductible?

Some commentators have suggested that only expenses of an income nature should be taken into account. The attraction of this argument is that it produces a symmetry between the calculation of the expenses which need to be paid and of the funds available to meet them. It may then be determined whether there is a need for additional funds to meet those expenses. If Parliament had intended to include capital expenses, why measure the need for funds solely by reference to the settlement's income, which income would not be applicable to meet those capital expenses?

There is some force in this argument. However, it does involve doing considerable violence to the ordinary meaning of the phrase "expenses of administration" many acts of the trustees which would clearly be part of their duties of administration would give rise to expenses properly chargeable to capital account (e.g., expenses in realising and reinvesting the trust fund). Similarly, if the policy of the provision was to exclude capital expenses, it would have been logical to have limited taxation expenses to income tax or taxes on income. In marked contrast, the draftsman has not limited the type of tax in any way. The absence of any words excluding capital expenses is particularly pronounced given the express words used in Taxes Act 1988 s.686(1)(d).

Allowing both capital and income expenses to be deducted is more consistent with the language used and should be the preferred construction unless it would lead to an absurd result. In the author's view, such a construction does not lead to absurd results. The purpose behind looking at the settlement's income alone was not to achieve an exact comparision between the settlement's expenses and the funds available to meet them. The validity of such a comparison is largely undermined by the absence of any carry forward provision for surplus unaccumulated income from previous years which could be used to meet the income expenses of the current year. Rather, concentrating on income receipts alone whilst permitting both capital and income expenses to be deducted provides a simple and easy-to-administer check on the sums coming into the trust each year compared with the sums which would have to be paid out that year. The trustees would normally have to prepare both the income figure and the expenses figure as part of their ordinary duties. Taking account of any increase in the capital value of the fund would involve the trustees and the Inland Revenue in considerable additional work, particularly if unrealised trust property had to be valued.

As noted above, the statutory language places no restriction on the type of tax expense which can be taken into account. It follows from this that non-UK taxes can be deducted. This approach would tie in with non-UK source income being included on the receipts side. It is understood that the Inland Revenue accept this view. Again, expenses are not limited to the direct cost of paying taxes but can include expenses incurred in preparing the relevant returns if not otherwise an expense of administration. But although the words "relating to" have a reasonably elastic meaning there is a point where the elastic snaps: if the trustees become liable to interest on late paid tax, particularly if the delay is culpable, it is most unlikely that such interest would be allowable.

Application of Contribution Towards Meeting Settlement's Expenses

Once the shortfall has been correctly calculated, the last condition is that the property should be contributed towards meeting the expenses which have given rise to the shortfall. There is no apparent time limit for the making of the contribution. However, as a practical matter, there will be limits as to how long the settlement can keep its creditors waiting. Where the contribution is made more than twelve months after the end of a year of assessment to which it relates, it would be prudent to allocate the contribution expressly to the relevant year lest it be attributed to another year. The trustees should be made aware of and accept the purpose for which the contribution is to be used.

It is hard to see how a contribution can be made towards meeting expenses if such expenses have already been discharged at the time when the contribution is made. Accordingly, if there is a shortfall for a year of assessment and further funds will be forthcoming, care should be taken not to discharge the surplus expenses out of existing funds.

Conclusion

Given the ambiguities in the legislation, the approach adopted by the Inland Revenue will be of even greater importance than usual. Certain informal rulings suggest that they are adopting a more pragmatic approach than a strict reading of the legislation would require. It is to be hoped that these informal rulings will be codified into a Statement of Practice on which the general body of taxpayers can rely. In the interim, the safest course is to obtain advance clearance that the amount of the proposed contribution complies with para 11(3).