The Offshore Tax Planning Review

OFFSHORE LOSSES

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Given present economic circumstances, it is not surprising that significant losses have arisen in many settlements and companies. This Article attempts to explain the way in which those losses are treated for United Kingdom capital gains tax purposes when they have accrued in a non-UK resident settlement or in certain types of non-UK resident companies.

Section 87

Section 87 of the Taxation of Chargeable Gains Act 1992 ("the 1992 Act"), formerly section 80 of the Finance Act 1981, applies to treat the capital gains of certain non-UK resident settlements as those of the beneficiaries. The provision applies to all settlements where, during any year of assessment, the trustees are at no time resident or ordinarily resident in the UK if the settlor is at any time during that year, or was when he made the settlement, domiciled and either resident or ordinarily resident in the UK. Broadly, the amount upon which the trustees would have been chargeable to tax, if they had been resident or ordinarily resident in the UK in the year, together with the corresponding amount in respect of any earlier such year, is attributed to the beneficiaries as their "chargeable gains" in proportion to the amounts of any capital payments received by them.

In addition to bringing such offshore capital gains within the scope of UK taxation, section 87 entitles non-resident trustees to deduct their losses from their chargeable gains, provided they arose in the same year of assessment. This is because, for any year of assessment in which section 87 applies to a settlement, it must be assumed that the trustees are UK resident, and if they had actually been resident or ordinarily resident in the UK they would have been so entitled (see section 2(2) of the 1992 Act).

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Yet, were it not for further specific provision, relief would not be afforded to offshore capital losses realised in earlier years of assessment. This is because a loss accruing to a person in a year of assessment during no part of which he is resident or ordinarily resident in the UK is not an "allowable loss" for capital gains tax purposes (as defined in section 16(3) of the 1992 Act). The assumption as to the residence of the trustees, made in order to calculate the amount upon which they would have been chargeable to tax, is made only in respect of an individual year of assessment; it is not an assumption that the trustees were continually resident in the UK throughout the entire period to which section 87 applied to the settlement. Furthermore, although section 87 attributes gains to beneficiaries, it nowhere deals with losses. Any losses, therefore, would without specific statutory provision to the contrary, remain those of the non-UK resident trustee and fall foul of section 16(3).

Accordingly, Parliament provided, in what is now section 97(6) of the 1992 Act, that,

> "Section 16(3) shall not prevent losses accruing to trustees in a year of assessment for which section 87 of this Act ... applied to the settlement from being allowed as a deduction from chargeable gains accruing in any later year ... ".

Losses accruing to the offshore trustees may thus be relieved against their future chargeable gains for the purpose of calculating the "trust gains" on which a beneficiary may ultimately be assessed. What, however, if the trustees of a settlement pregnant with losses appoint trust property to a beneficiary absolutely? If the settlement was UK resident at the time of the appointment, then any "allowable loss" which had already accrued to the trustees in respect of the property which was, or was represented by, the property to which the beneficiary became entitled, would be treated as if it had accrued at that time to the beneficiary, instead of to the trustees (see section 71(2) of the 1992 Act). But as has already been noted, a loss accruing to offshore trustees is not an "allowable loss", and although section 97(6) of the 1992 Act allows a deduction for certain purposes in respect of such losses, it does not go so far as to specifically deem them to be allowable losses.

Section 97(6) therefore has only a limited scope. On an absolute appointment to a UK resident beneficiary of the entire trust fund by the trustees of a non-UK resident settlement with realised capital losses, section 71(2) would not apply and the unrelieved losses would simply disappear. Section 97(6) would not prevent that result. If the legislative intention had been otherwise, namely to treat all losses accruing in a settlement in a year of assessment for which section 87 applied as being "allowable losses", the draftsman could simply have provided that:

> "Section 16(3) shall not prevent losses accruing to trustees in a year of assessment for which section 87 of this Act applied to the settlement from being allowable losses."

In section 97(6) as it is actually drafted the draftsman refers first to "losses accruing to trustees", and then, later, to "chargeable gains accruing". It is implicit that the second use of the word "accruing" must be limited by the first, and refers only to the trustees.

Possibly this point is not free from doubt. Indeed, Simon McKie in his book *Capital Gains Taxation of Non-Resident Settlements* (Sweet & Maxwell 1991) adopts the contrary view. Sadly, however, he does not justify his conclusions and the present authors do not share them.

Section 86

A similar situation arises in relation to settlements falling within the provisions of section 86 of the 1992 Act (a provision originally introduced as Schedule 16 to the Finance Act 1991). Section 86 applies if among other things (i) the trustees of a settlement are neither resident nor ordinarily resident in the UK during any part of a year, (ii) the settlor is domiciled in the UK at some time in the year and is either resident in the UK during any part of the year or ordinarily resident in the UK during the year, and (iii) by virtue of disposals of any of the settled property originating from the settlor, there would be an amount on which the trustees would be chargeable to tax for the year if the assumption were made that the trustees were resident or ordinarily resident in the UK throughout the year.

Where section 86 applies, the amount upon which the trustees would if UK resident be chargeable to tax for the year of assessment is treated as accruing to the settlor in that year as chargeable gains of the settlor (section 86(4)(a)).

As with section 87, the assumption as to the residence of the trustees, for the purpose of calculating the sum upon which they would be chargeable to tax, is made only in respect of individual years of assessment, and does not encompass earlier years. Accordingly, although losses may once again be relieved against chargeable gains accruing in the same year of assessment, any losses accruing in earlier years would not be allowable losses, and would not, therefore, be relieved against chargeable gains accruing in subsequent years in the absence of specific provision.

In the authors' view, section 97(6) again offers only limited comfort. It has already been noted that for section 97(6) to apply, a loss must arise in a year of assessment to which section 87 applied to the settlement. Section 87 applies to a

settlement for any year of assessment during which the trustees are at no time resident or ordinarily resident in the UK if the settlor is at any time during that year, or was when he made the settlement, domiciled and either resident or ordinarily resident in the UK. The language of section 87 is, therefore, wider in its scope than that of section 86 - so much so that if section 86 applies to a settlement, section 87 will always apply also. Furthermore, the draftsman has acknowledged that the sections can both apply to a single settlement by providing, in section 87(3), for the deduction from gains chargeable under section 87 those which have already been charged by virtue of section 86.

It is because section 87 applies to the settlement in years to which section 86 applies that advantage can, in the authors' view, be taken of section 97(6) to make past losses available in the computation of the gains on which a settlor may be chargeable under section 86.

The assumption as to the residence of the trustees in section 86(1)(e) and (3), as has already been noted, is made in order to calculate the amount upon which the trustees would have been chargeable to tax under section 2(2) of the 1992 Act. This naturally involves calculating the trustees' chargeable gains. The situation is strikingly similar to one in which section 87 alone would apply, save that the chargeable gains are here accruing to the settlor rather than a beneficiary; one calculates the trustees' chargeable gains, and then one makes the assumption that those chargeable gains have accrued to the settlor.

Because of the operation of section 97(6) it is permissible to deduct losses which have accrued to the trustees in earlier years of assessment from the chargeable gains accruing to them in a later year. Any balance of gains is treated as accruing to the settlor in any year of assessment under consideration for the purposes of section 86. What the settlor cannot do is relieve any losses accruing to the offshore trustees against his own actual chargeable gains; the losses remain dormant within the settlement only to go to reduce the settlor's potential tax liability arising from any future deemed chargeable gains (being actual gains of the trustees deemed to be the settlor's by section 86). Once again, if no such gains arise before the settlement comes to an end then those losses will simply disappear.

Immigrant Settlements

It is worth mentioning one additional trust-related topic: immigrant settlements. The immigrant settlement provisions are contained in section 89 of the 1992 Act. By "immigrant settlement" the authors mean a settlement which ceases to be non-UK resident and becomes UK resident.

Broadly, where a period of one or more years of assessment for which section 87 applies to a settlement ("a non-resident period") is succeeded by a period of one or more years of assessment for each of which section 87 does not apply to the settlement ("a resident period"), any remaining trust gains are treated as chargeable gains accruing in the first year of the resident period to beneficiaries of the settlement who receive capital payments from the trustees in that year; and so on for the second and subsequent years until the amount treated as accruing to the beneficiaries is equal to the amount of the trust gains for the last year of the non-resident period.

But what if, when the non-resident period ends, and the resident period commences, there are no trust gains; instead there are trust losses? One must once again resort to section 97(6), which still applies because although the losses need to have accrued to the trustees in the non-resident period, they may be deducted from capital gains accruing in *any* later year.

In the authors' view, losses which have accrued during the settlement's non-resident period may therefore be relieved against chargeable gains accruing *to the trustees* during the settlement's resident period. The losses do not disappear merely because there has been a change in trustees from non-UK resident trustees to UK resident trustees, as the trustees themselves are deemed to form a single continuous body (see section 69(1) of the 1992 Act).

If the newly UK-resident settlement still has unrelieved losses when capital payments are made to UK-resident beneficiaries then, in the authors' view, the same consequences must follow as did when such payments were made from the settlement by the trustees during the non-resident period. In other words, as the losses are not specifically deemed to be allowable losses, the recipient beneficiaries of capital sums will be unable to "inherit" those losses. The position therefore is that losses accruing to the trustees during the resident period are allowable losses capable of falling within the section 71(2) deeming provisions, and accordingly being treated as accruing to a recipient beneficiary of trust property. By contrast, any losses which accrued during the non-resident period remain "non-allowable". Immigration of the settlement does not operate retrospectively in such a way as to transform losses which accrued in the non-resident period into allowable losses.

Offshore Companies

Special treatment is given to capital losses arising in non-UK resident companies which, but for their non-resident status, would be close companies if they were resident in the UK. The provisions relating to these companies are to be found in section 13 of the 1992 Act.

Broadly, the chargeable gains of such companies are apportioned to those shareholders who are, at the time when the gains accrue, resident or ordinarily resident in the UK and, if individuals, are domiciled in the UK. A non-resident company's chargeable gains will also fall to be apportioned to trustees owning shares in the company if they are neither resident nor ordinarily resident in the UK when the gain accrues to the company. The deemed chargeable gains of non-resident trustees will not, of course, be charged to tax in the trustees' hands, but will fall to be charged pursuant to section 86 or 87 of the 1992 Act in the manner discussed earlier. In all cases, the apportionment of the non-resident company's chargeable gains to its shareholders is equal to the proportion of the assets of the company to which that person would be entitled on a liquidation of the company at the time when the chargeable gain accrues to the company, provided that the proportion of the chargeable gain attributable is not less than one-twentieth. This basis of attribution offers scope for avoidance, but that is a topic beyond this Article.

If, rather than chargeable gains accruing in such non-resident companies, losses accrue instead, section 13(8) of the 1992 Act provides that:

> "So far as it would go to reduce or extinguish chargeable gains accruing by virtue of this section to a person in a year of assessment this section shall apply in relation to a loss accruing to the company on the disposal of an asset in that year of assessment as it would apply if a gain instead of a loss had accrued to the company on the disposal, but shall only so apply in relation to that person and subject to the preceding provisions of this sub-section this section shall not apply in relation to a loss accruing to the company."

Therefore, as with non-UK resident settlements, despite detailed provisions charging gains, only a very limited form of relief is afforded with regard to losses.

The precise scope of section 13(8) warrants further consideration. Significantly the provision only permits reference to individual years of assessment. And it only allows loss relief against gains attributed by section 13 itself. In any given year losses accruing to the non-resident company may be attributed along with any chargeable gains. If the losses are such as not only to extinguish all of the attributed chargeable gains in that year but in addition to leave a "loss surplus", that surplus will simply vanish. These losses cannot be carried back or forward in order to reduce past or future chargeable gains. Nor can the surplus loss be utilised by the participator in the company. There is a once and for all window of opportunity in which such losses can be relieved, which means very careful planning is needed to ensure that losses in such companies are not wasted.

Suppose, however, that attributable gains arose in a year in which a shareholder had not only attributable losses but personal allowable losses also. Must the shareholder relieve his allowable losses against his attributable gains in priority to his attributable losses, with the risk that his attributable losses may be lost? In the authors' view the answer must be no. Section 13 contains an all-embracing code to be applied to the gains and losses of the non-resident companies to which it applies. That is not to say that once a shareholder has set his attributable losses against his attributable gains he cannot relieve any allowable losses against attributable gains which remain; in the authors' view he can. What is suggested is simply that attributable losses must be relieved against attributable gains in priority to allowable losses.

Finally, although section 13(8) only allows a loss accruing to a company in a year of assessment to be used to reduce or extinguish attributable gains accruing by virtue of section 13 in that year of assessment, section 13(8) does not provide that the attributable gains must have accrued in the same company in which the loss accrues. Although not free from doubt, the authors consider it at least arguable that if, in the situation where a person holds shares in, say, two companies to each of which section 13 applies, and one realises attributable gains and the other attributable losses in the same year of assessment, section 13(8) would enable one to be set against the other.