The Offshore Tax Planning Review

DEFINITION OF "SETTLOR"

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In *Fitzwilliam v IRC* [1993] STC 502 at 516 Lord Keith considered the definition of "settlor" for the purposes of Inheritance Tax. The events with which the House of Lords were concerned in that case occurred in 1980 when the relevant legislation was the Finance Act 1975 and the definition of "settlor" was contained in paragraph 1(6) of Schedule 5. An identical definition is now contained in s.44 IHTA 1984 and reads as follows:

"**Settlor**

(1) In this Act "settlor", in relation to a settlement, includes any person by whom the settlement was made directly or indirectly, and in particular (but without prejudice to the generality of the preceding words) includes any person who has provided funds directly or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement.

(2) Where more than one person is a settlor in relation to a settlement and the circumstances so require, this Part of this Act (except section 48(4) to (6)) shall have effect in relation to it as if the settled property were comprised in separate settlements."

By a Deed of Appointment dated 14th January 1980 the trustees of the Will of Earl Fitzwilliam appointed that a part of the residuary estate to the value of £3.8m should be held on trust to pay the income to Lady Fitzwilliam until whichever was the earlier of 15th February 1980 and the date of her death; subject thereto as to one moiety in trust for Lady Hastings absolutely. By a Settlement dated 5th February 1980 Lady Hastings settled a sum of £1,000 on trustees on trust to pay the income thereof to Lady Fitzwilliam until her death or until 15th March 1980 (whichever should first occur) and subject thereto on trust as to both capital and income for Lady Hastings absolutely. By a Deed of Assignment dated 7th

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February 1980 Lady Hastings assigned to those trustees her absolute reversionary interest in the vested moiety to be held by them as an addition to the funds of Lady Hastings' Settlement.

The Crown argued that by virtue of the appointment of 14th January 1980 property was provided to Lady Hastings directly or indirectly for the purpose of, or in connection with, the Settlement which Lady Hastings later made on 5th February 1980. The person who provided that property was said to be Earl Fitzwilliam because the appointment by the trustees fell to be read back into his Will under the principle of *Muir v Muir* [1943] AC 468 and *Pilkington v IRC* [1964] AC 612. Those cases decided that for the purposes of the rule against perpetuities the exercise of a power of appointment must be written into the instrument creating the power. Earl Fitzwilliam, therefore, the Revenue argued, was to be treated as the settlor so far as concerned the trusts contained in the appointment made by his trustees on 14th January 1980 but Lord Keith held that he could not reasonably be regarded as having provided property directly or indirectly for the purposes of or in connection with the Settlement made by Lady Hastings on 5th February 1980. The words "for the purpose of or in connection with" connoted that there must at least be a conscious association of the provider of the funds with the settlement in question. It was clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise, anyone who gave funds unconditionally to another which that other later settled would fall to be treated as the settlor or as a settlor of the funds.

The purpose of this article is to consider the possible implications of Lord Keith's view of the Inheritance Tax definition of the word "settlor" in the light of the fact that the definition is similar for the purposes of Income Tax and Capital Gains Tax.

The Income Tax definition (for the purposes of Chapter III of the Taxes Act) is now contained in s.681(4) Taxes Act 1988 and reads as follows:

> ""settlor", in relation to a settlement, means any person by whom the settlement was made; and a person shall be deemed for the purposes of this Chapter to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular without prejudice to the generality of the preceding words, if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."

Section 97(7) TCGA 1992 says that for the purposes of ss.87-96 (the offshore settlement provisions) the words "settlement" and "settlor" have the meaning given by s.681(4) Taxes Act 1988 and "settlor" includes, in the case of a settlement arising under a Will or intestacy, the testator or intestate.

It will be observed that the two definitions are not identical. The IHT definition includes the words "or in connection with" which do not appear in the Income Tax definition, and the latter includes the words "or entered into" and "or undertaken to provide" which do not appear in the IHT definition. These differences do not appear material in the context of this article.

The leading case on the Income Tax definition is *Mills v IRC* [1972] 2 All ER 86. This well-known case concerned the film actress Hayley Mills. When she was aged 14 and about to start her film career her father caused a company to be formed and the shares were allotted or transferred to him or his advisers as his nominees and later transferred to them jointly. The shares were then settled by Hayley Mills' father as settlor upon Hayley Mills contingently on her attaining the age of 25 absolutely but with the benefit of the intermediate income, with trusts for her children or other appointees in default and with an ultimate trust in default for her father who retained for life the power to appoint new trustees. Hayley Mills then entered into an agreement exclusively to serve the company for five years at £400 p.a. Subsequently the company and a film company entered upon a lucrative five year contract which had been in the expectation of her father from the start. The company paid substantial dividends to the trustees. The House of Lords held that since the source of the dividends was the money paid for the taxpayer's work which, but for the arrangements made by her father, would have been received by her, they had been "provided" by her not just by the company. Furthermore, they had been "provided ... for the purpose of the settlement" within the definition set out above.

It is suggested that Lord Keith's remarks in *Fitzwilliam* may have implications in connection with the conferment of benefits from offshore trusts on UK residents, particularly where there are transfers between settlements or the original settlor is dead.

One example would be that of a UK resident and domiciled settlor who twenty years ago made a settlement offshore. The assets of the settlement may also be offshore but some or all the living beneficiaries are UK resident and domiciled. The settlor died ten years ago. Accordingly, s.740 Taxes Act 1988 will apply to any distributions of accumulated income to UK resident beneficiaries and s.87 TCGA 1992 will apply to capital payments to UK resident and domiciled beneficiaries.

Can unapplied income (i.e., income which the trustees have not decided to distribute or accumulate) be said to be derived directly from the settlor of the original capital? There cannot, in the words of Lord Keith, possibly be "a conscious association" between a settlor, particularly one who is dead, with income produced by the funds originally derived from him. Therefore, if such income is transferred, pursuant to an appropriate power in the settlement, to the trustees of a Declaration of Trust set up by another offshore trust company with its own funds for a class of beneficiaries similar to those benefiting under the original settlement,

does this break the link connecting the funds to the original settlement? Such income would by reason of its application be capital of the new settlement and seemingly outside the provisions of s.87 TCGA 1992.

By contrast, s.86 TCGA 1992 deals with the attribution of gains to **settlors** with an interest in non-resident settlements; these are the Finance Act 1991 provisions. In Schedule 5 para 7 of the 1992 Act a person is defined as being a settlor in relation to a settlement if the settled property consists of or includes property originating from him, and para 8 states that "property originating" comprises not only property provided by the settlor (and property representing it) but also income from property originating from a person. These provisions apply, however, only to settlements created on or after 19th March 1991.

Nevertheless, it is interesting that a definition of "originating" was thought to be necessary together with an express reference to income. This suggests that there is a doubt whether the income tax definition set out above does include income or property representing income.

The transfer technique suggested above could not be effectively used for a transfer of capital from one settlement to another. Ssection 90 TCGA 1992 applies to such transfers where s.87 applies to the transferor settlement, (i.e., a settlement of which the settlor is, or was when he made the settlement, domiciled and either resident or ordinarily resident in the UK), but if s.87 does not apply to the transferee settlement then s.89(2) will apply so as to treat the trust gains (or the outstanding part of them) as transferred to it. The UK tax status of the transferee settlement is immaterial, i.e., irrespective of the residence or domicile of the settlor or trustees, it will be treated as having trust gains which will cause tax to be payable by UK resident and domiciled beneficiaries on any capital payments.

To summarise, therefore, it seems possible that unapplied income in a pre-1991 offshore settlement which has not been "tainted" is not "provided directly or indirectly" by the settlor and could be transferred to another settlement (to comprise its capital) without being caught by s.739 or s.740 Taxes Act 1988 or s.87 TCGA 1992.

A quite different point arises in connection with the annual exemption from Capital Gains Tax available to UK resident trusts. By virtue of TCGA 1992 Sch. 1 the annual exemption is available in full only to the trustees of a settlement made before 7th June 1978. In relation to settlements made after that date the trustee annual exemption has to be divided between all settlements made by the same settlor. Where there have been transfers from the original settlement into settlements made with a nominal sum of money by a third party after 7th June 1978, does Lord Keith's requirement of a "conscious association" preclude the sub-division of the annual exemption?