The Offshore Tax Planning Review

REVENUE BITE THE HELPING HAND
A Consideration of IR Statement Practice 4/92

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On 29th May 1992, the Revenue issued two Extra-Statutory Concessions and a major Statement of Practice dealing with the capital gains tax treatment of non-UK resident trusts. The mere existence of these documents is an indictment of the 1991 legislation. That legislation raised many questions, and only some have been answered by the Statement of Practice. In this article I wish to concentrate on two topics which are important to practitioners: the "administrative expenses" proviso (TCGA 1992 sched 5 para 9(3)) and the giving of guarantees by settlors.

Expenses of Administration

Before TCGA 1992 sched 5 will apply to a settlement one of the "conditions" in para 9 must be satisfied. The first of these conditions is that:

> *" ... on or after 19th March 1991 property or income is provided directly or indirectly for the purposes of the settlement -*
>
> *(a) otherwise than under a transaction entered into at arm's length, and*
>
> *(b) otherwise in pursuance of a liability incurred by any person before that date;"*

The proviso, which was added to the Bill at a very late stage, is in the following terms:

> *"... 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 of this condition if the value of the property or income so provided does not exceed the difference*

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> *between the amount of those expenses and the amount of the settlement's income for the year".*

The consequence of adding, even slightly, too much property is that the settlement becomes a "qualifying settlement" forever afterwards. The proviso raises many questions of construction. A number of these were discussed in an earlier edition of this Review by Giles Goodfellow in an article entitled "Bailing out Overseas Settlements: The Pitfalls of Lending a Hand" (OTPR Vol 2, 1991/92, Issue 1 p.75). In paras 25-32 of the Statement of Practice, the Revenue have given their view of the answer to some of these questions.

First, the expenses can be those properly chargeable either to the income or the capital of the trust. It had been feared that the reference to the excess of expenditure over income indicated that only income expenses would qualify. It still seems to the writer odd that when one is asking whether a settlor can safely add funds to enable trustees to discharge a capital expense, one should take into account the amount of income which has arisen in the year which could never have been used to discharge the capital expense. In any event, the Revenue's view is clearly expressed.

The second question addressed is: what is meant by "expenses relating to administration". The only guidance given is a list of expenses which the Revenue do *not* regard as such expenses:

> " - *loan interest (other than interest on a loan taken out to meet expenses of administration within the terms of the proviso);*
>
> - *the costs of acquiring, enhancing or disposing of an asset;*
>
> - *expenses incurred in connection with a particular trust asset to the extent that such expenditure can be set against income arising from the asset. For the purpose of the proviso to paragraph 9(3), the measure of the gross income from such a source is net of expenses."*

The first exception is really begging the question what are "expenses of administration within the terms of the proviso". The second exception, however, appears to contradict the original general proposition that both capital and income expenses are included. Buying and selling investments is surely part of the administration of the trust fund. The trustees are acting in exercise of their administrative, rather than dispositive, powers. While it is obviously correct that the purchase price itself is not an administrative expense, incidental costs of purchase clearly are. Similarly, costs of disposal are expenses incurred in administering the trust. Enhancement expenditure, on the other hand, is a further investment of trust monies, and so cannot be an expense of administration.

The third exception must be based on two propositions. First, since the expense can be paid out of particular income, there is no justification for any addition to the trust fund. Secondly, it does not affect the overall computation because the income from the asset will be reduced, for the purposes of the proviso calculation, by the expenditure.

The phrase "expenses relating to taxation" is given a very liberal interpretation by the Revenue. They specifically state it includes both UK and foreign taxes. The clear implication is that it covers all forms of taxation and not simply taxation on income. It also includes interest and penalties on tax, and costs incurred in obtaining information regarding the tax liabilities of beneficiaries.

Unfortunately for a Statement of Practice, part of para 29 is just as difficult to understand as the legislation which it is purporting to interpret. Paragraph 29 states that a capital expense paid out of trust income is not to be treated as a provision by the income beneficiary provided that either:

> " - *the trust deed permits payment of capital expenses from income and the beneficiary is entitled only to net income after such payments; or*
>
> - *the trustees borrow money from the income account which is subsequently restored, along with interest over the period of the loan. The appropriate rate of interest is considered to be that which a Court of Equity would order on the replacement of trust income."*

The first part is obviously correct. If the life tenant has no entitlement to the income used to meet the capital expenses then he cannot have "provided" that income. The second part, however, is very unclear. Trustees could borrow money from an income account in three circumstances:

(i) there is a specific power for them to do so in the settlement;

(ii) there is a short term emergency due to lack of capital liquidity; or

(iii) the life tenant authorises the loan.

Circumstance (i) is, in the writer's experience, rare. In such a case, however, it is difficult to see how there is any "provision". The trustees are simply exercising a power given to them by the settlement. In circumstance (ii) the trustees would be acting technically in breach of trust. However, no loss would be suffered if the money was repaid with interest when capital funds became available. Again, there can be no "provision" by the life tenant because he played no part in the transaction. In contrast, in circumstance (iii), a "provision" can be identified as the life tenant is, in effect, making a loan to the trustees. In order for para 29 to

be consistent with para 22, it must be assumed that a loan of this sort is on commercial terms if it is at the rate of interest which a Court of Equity would order. This rate is normally the rate of the Court's special account: see *Bartlett v Barclays Bank Trust Company Limited* [1980] Ch 515, 547. This is currently equal to the base rate (i.e., 8%), which is lower than a normal commercial rate of interest. This is a puzzling inconsistency.

Guarantees

Paragraph 35 of the Statement of Practice provides:

> *"The giving of a guarantee is regarded as an indirect provision of funds ... Payment of an obligation under a guarantee given before 19th March 1991 is, in general, regarded as a payment in pursuance of a liability incurred before 19th March 1991 and within paragraph 9(3)(b). This may not, however, apply where -*
>
> - *the contingent liability under the guarantee cannot be quantified with a sufficient degree of accuracy, e.g., where the guarantee is open-ended or the contingency is remote; or*
>
> - *the guarantor does not take reasonable steps to pursue his rights against the debtor."*

The first sentence is probably an over-simplification of a problem the solution to which may turn on the precise facts of a particular case. I do not, however, propose to reopen that old debate. Instead, I wish to concentrate on the second sentence of para 35. In the author's view, a payment under a guarantee entered into before 19th March 1991 cannot be a relevant provision of funds (assuming that it is such a provision) because it is made in pursuance of a liability incurred before the relevant date. It is difficult to see what difference it makes that the liability is "open-ended" or that the contingency is remote. The guarantor is bound to pay under the guarantee, that was a liability entered into before 19th March 1991, and that is the end of the matter. The next, wholly separate, question is whether the guarantor provides funds by not exercising his rights of subrogation against the settlement. This turns on the meaning of the word "provided" in Sched 5 para 9. Does this word bear a wide meaning which would encompass not enforcing a right? In the author's view the word "provided" is *capable* of bearing such a wide meaning; however, this is a difficult question which is not specifically addressed in the Statement of Practice.

Conclusion

My major criticism of the Statement of Practice is that it tends to make specific assertions, generally unsupported by reasoning. It would have been far more useful if the Revenue had given guidance on their interpretation of concepts such as 'provision'. This would have allowed taxpayers and their advisors to predict how the Revenue will apply the legislation in the wide variety of situations which occur in practice.