

THE TAXATION OF ONWARD GIFTS FROM SETTLEMENTS FOLLOWING THE FINANCE ACT 2018

Rory Mullan¹

1. An important element of the anti-avoidance provisions relating to settlements in Schedule 10 Finance Act 2018 relates to the taxation of onward gifts. Unfortunately those provisions are not drafted in an accessible manner.
2. The idea of these provisions is that it should not be possible to avoid tax charges by making a transfer from an offshore trust to a beneficiary who enjoys favourable tax treatment (e.g. a non-resident) and having that beneficiary then transfer the assets he has received to another person who does not enjoy a favourable tax treatment. Broadly, the intermediate gift is ignored and the final recipient is taxed as if the transfer were to him directly.
3. Three parallel sets of provisions operate in a similar way in relation to catch onward gifts within their scope:
 - 3.1 For capital gains tax new sections 87I to 87M TCGA 1992 have been introduced;
 - 3.2 For the transfer of assets abroad section 733B to 733E ITA 2007 are introduced;
and
 - 3.3 In relation to the settlements provisions sections 643I to 643N ITTOIA 2005 are introduced.

1 Rory Mullan, Old Square Tax Chambers, 15 Old Square, Lincoln's Inn, London WC2A 3UE; T: (020)7242 2744 F: (020)7831 8095; E-mail: rorymullan@15oldsquare.co.uk

4. Although there are similarities in relation to the provisions as they apply to each of these three codes, there are also some differences which largely derive from the way in which the charges operate.
5. The purpose of the amendments is to ensure that gains of offshore trusts are subject to taxation when beneficiaries receive benefits from that offshore trust regardless of intermediate transfers. The underlying charging provisions raise questions of EU law, particularly as to the proportionality of measures in question. The suite of measures in Schedule 10 FA 2018 do not improve compliance with EU law. Rather, they exacerbate the breach by seeking to increase the scope of the charge without improving its focus by reference to any principle other than collecting the largest amount of tax possible. That, however, is not the topic of this talk.

CAPITAL GAINS TAX PROVISIONS ON ONWARD GIFTS

6. Section 87 TCGA 1992 attributes gains of non-UK resident settlements to beneficiaries who are in receipt of capital payments. A similar provision applies in parallel under Schedule 4C TCGA 1992.

The matching rules

7. It is helpful to briefly recap the way in which the matching rules operate as they feed into the operation of the onward gifts rules.
8. Gains within the trust are matched to capital payments received by beneficiaries as provided by section 87A TCGA 1992 broadly on the basis that:
 - 8.1 later gains are matched to capital payments before earlier gains; and
 - 8.2 later capital payments are matched to gains in priority to earlier capital payments (so far as those earlier capital payments have not already been matched).
9. By way of example:
 - Year 1 gain of £50
 - Year 2 gain of £50
 - Year 3 gain of £50, capital payment of £75

Year 4 capital payment of £120

Year 5 gains of £75, capital payment of £50

10. Year 3 is the first year of capital payments, and the first year of potential charge. The £50 gain accruing to the trustees in year 3 will be matched with this capital payment, leaving £25 unmatched. That £25 will then be matched with £35 gain from year 2 (leaving £25 unmatched year 2 gain).
11. In year 4 the capital payment will be matched to the £25 unmatched gain from year 2 and the £50 gains from year 1, leaving £50 of the capital payment unmatched.
12. In year 5, the £50 capital payments will be matched with £50 of the gains from year 5. The £25 gains left over will then be matched with £25 of the unmatched capital payment from year 4.

Capital payments which did not attract an immediate charge

13. Prior to the introduction of section 87D TCGA 1992 capital payments to non-residents could be matched with gains. Such payments are now no longer treated as capital payments.
14. Additionally, section 87B applies a remittance basis to gains treated as accruing to an individual under section 87 TCGA 1992. It treats such gains as foreign chargeable gains if that individual is a remittance basis taxpayer. This means that such capital payments will not be subject to charge unless remitted to the UK.

Taxation of onward gifts: the old law

15. This leaves open the possibility of planning whereby the trustees of a settlement appoint property to a beneficiary who is non-resident or a remittance basis taxpayer without an immediate charge to capital gains tax applying. That raises a question as to what happens if that beneficiary were to transfer the appointed property to a UK resident and domiciled taxpayer (“the UK beneficiary”) – assuming that such transfer does not itself result in a remittance.
16. Under previous rules, the onward transfer would not have been caught by the charge. The first appointment would have washed the capital payment allowing it to be enjoyed by the UK beneficiary without charge.

17. There may have been an argument as to whether this was in itself a capital payment from the trustees of the settlement. That was on the basis that settlement has the meaning given by section 620 ITTOIA 2005:

“settlement” includes any disposition, trust, covenant, agreement, arrangement or transfer of assets (except that it does not include a charitable loan arrangement),

18. Although this wider definition of settlement arguably would catch onward gifts in certain circumstances, it was clearly not regarded as sufficiently comprehensive. New legislation now seeks to catch onward gifts in a much more detailed and prescriptive manner.

The new rules

When do the new rules apply

19. The starting point is to identify when the new rules apply. This is set out in section 87I TCGA 1992 (which is perhaps easier to follow than its income tax counterparts).
20. The rules can apply to a straight gift (albeit direct or indirect) from the person who receives a benefit from the trust (described as the Original Beneficiary) to another person (described as the Subsequent Recipient) or where there are a number of transfers whereby property goes from the Original Beneficiary to the Subsequent Recipient.
21. There are six positive requirements which must be met in relation to a straight gift from the Original Beneficiary to the Subsequent Recipient. These are replicated in very similar form in each place where onward gift provisions appear:
 - 21.1 **An original payment:** a capital payment is received by the Original Beneficiary in the payment year from the trustee of a settlement.
 - 21.2 **An onward payment:** the Original Beneficiary makes an onward payment to the Subsequent Recipient in the gift year. The onward payment can be direct or indirect and includes the conferral of any benefit.
 - 21.3 **The Original Beneficiary:** must be non-resident and/or a remittance basis taxpayer in at least one tax year from the payment year to the gift year.

- 21.4 **The Subsequent Recipient:** must be UK resident in the gift year or (if the onward payment precedes the original payment) in the payment year.
- 21.5 **The timing:** the onward payment is either (i) within 3 years of the gift (or the deemed gift if the Subsequent Recipient is subsequently treated as an Original Beneficiary) or (ii) is before the original payment but it is reasonable to assume that it is in anticipation of the original payment. (This payment is deemed to be made immediately after the original payment)
- 21.6 **Tracing the property:** the onward payment must include either (i) the whole or part of the original payment, (ii) anything which derives from or represents the original payment or (iii) other property if the original payment is made with a view to enabling or facilitating the onward payment.

Must arrangements be in place?

- 22. The provisions will not apply if it can be shown that either there are no (i) arrangements (defined in loose terms) for or an intention as to the passing on of the original payment or (ii) that there is no reasonable expectation that the Subsequent Recipient will be resident in the UK when he receives at least part of what is being passed on.
- 23. The drafting of this last exception is tortuous and possibly misleading. On first glance this appears to be a positive a requirement (section 87I(1)(b) TCGA 1992). On a closer reading it becomes apparent that this is requirement which is assumed to be met (if the provisions as to tracing and timing are met) so not a requirement at all unless the contrary can positively be shown (section 87I(8) TCGA 1992).
- 24. This may, nevertheless be relevant in circumstances where there is evidence to show a change in circumstances which was unanticipated and which lead to the change in approach.

Multiple gifts

- 25. Where there are two or more gifts in a series they may be caught by the provisions as to indirect gifts. In addition, there is provision where each intermediate beneficiary is non- UK resident and the tracing condition is met, the last gift is treated as if made by the Original Beneficiary.

26. Multiple gifts to a single beneficiary in a given year are treated as a single gift among which suitable apportionments are made.

The relationship between the original payment and the onward payment

27. The original payment is potentially subject to the application of section 87A TCGA 1992 in the hands of the Original Beneficiary. It may be subject to charge in the hands of the Original Beneficiary, it may be potentially subject to charge because of the application of the remittance basis or it may not be matched to trust gains at all (particularly if the Original Beneficiary is non-resident).
28. Section 87J TCGA 1992 requires that the original payment be divided into three parts to reflect this:
 - 28.1 The part which has been matched to trust gains for years not later than the gift year and which has been taxed (either because the remittance basis does not apply or it has been remitted);
 - 28.2 The part which has been matched to trust gains for years not later than the gift year but which has not been taxed (because the remittance basis applies to it); and
 - 28.3 The remaining part (the unmatched amount).

Attribution of gains to the Subsequent Recipient

29. The charge applies to the amount of the onward payment which can be traced to the original payment, but will not exceed the amount of that original payment.
30. The onward payment is taxed in the first place as if it were a payment from the trustees to a beneficiary up to the amount of any unmatched amount, that is to say that part of the original payment which was not matched with trust gains.
31. To the extent that the amount of the onward payment which is traced back to the original payment exceeds the unmatched amount, it will be treated as made up of the matched but untaxed amount (i.e. the amount to which the remittance basis applied). It will be treated as chargeable gains in the hands of the Subsequent Recipient.
32. There is a corresponding reduction of the section 87 TCGA 1992 gains treated as accruing to the Original Beneficiary.

33. Assuming:
- 33.1 Capital payment of £100 to UK resident remittance basis taxpayer and trust gains of £50.
 - 33.2 Although the £50 trust gains are matched to the capital payment, if they are not remitted there is no charge.
 - 33.3 If there is an onward gift of £75 to a UK resident domiciliary which can be traced to the capital payment then it is treated as being (i) a payment of £50 (which can be matched to trust gains) and (ii) chargeable gains of £25.
 - 33.4 At the same time the unremitted gains of Original Beneficiary will be reduced by £25.

Subsequent Recipient is a remittance basis taxpayer

34. Section 87M TCGA 1992 makes provision for the situation where the onward recipient is a remittance basis taxpayer. It is not easy to follow, with its references to “the person”. It appears that this in fact means the Subsequent Recipient. The explanatory notes explain:

New section 87M provides that where section 87K treats an unmatched amount as being received by, or chargeable gains as accruing to, a remittance basis user; and section 87L does not treat it as received by, or accruing to, the settlor; then section 87I(1)(a) has effect as if the capital payment were received by the remittance basis user. The rules in section 87I can operate again on any further onward payments of amounts which have not been remitted.

35. To the extent that unmatched payments are received by the Subsequent Recipient, such payments are treated as if the Subsequent Recipient were an Original Beneficiary who received the payment at the time of receipt by the Subsequent Recipient. The rules otherwise applying to tax unmatched payments in the hands of the Subsequent Recipient do not apply.
36. To the extent that untaxed amounts would be treated as accruing to the Subsequent Recipient, that is treated as a receipt by an Original Beneficiary of an unremitted amount. The chargeable gain treated as received by the Subsequent Recipient is reduced accordingly.

37. Subsequent gifts by the Subsequent Recipient are then treated in the same way as if the onward payment to that Subsequent Recipient were an original payment from which further onward payments can be made.
38. The limited exception for the situation where arrangements are not in place is not applied in relation to any further onward payments.

Subsequent Recipient is a close member of settlor's family

39. Where the Subsequent Recipient is a close member of the settlor's family, then the settlor is chargeable as if he had received the onward payment instead of the Subsequent Recipient (section 87J TCGA 1992).

TRANSFER OF ASSETS ABROAD AND ONWARD GIFTS

40. The Transfer of Assets abroad code (ToAA) imposes a charge on recipients of benefits separately to that which applies to transferors. This is the familiar charge under section 732 ITA 2007 where there has been a transfer of assets which together with associated operations results in income arising to a person abroad and an individual who receives a benefit out of assets available as a result of that transfer and/or associated operations.
41. The charge applies by reference to the benefits received by the individual in that and earlier tax years. These are matched to income which arises to the person abroad and which can be used directly or indirectly to provide a benefit to the individual.
42. A charge applies on the amount of previously untaxed benefits in a given tax year up to the amount of relevant income which has not previously been matched and charged.

The onwards payments charge

43. The onwards payments rules apply if conditions similar to those which apply in the capital gains tax context are met:
 - 43.1 **A benefit:** an amount of income is treated as arising to the Original Beneficiary under section 732 ITA 2007 in the arising year otherwise than under the onward gift provisions themselves.
 - 43.2 **Matching:** the amount of income must be matched under section 735A ITA 2007 with (i) protected foreign income and (ii) a benefit

received by the Original Beneficiary (section 733B(1)(b) ITA 2007).

- 43.3 **An onward payment:** the Original Beneficiary makes an onward payment to the Subsequent Recipient. The onward payment can be direct or indirect and includes the conferral of any benefit.
 - 43.4 **The timing:** the onward payment is either (i) within 3 years of receipt of the benefit (or deemed receipt where the Original Beneficiary was the Subsequent Recipient in relation to a previous onward payment) or (ii) is before the original payment but it is reasonable to assume that it is in anticipation of the original payment. (This payment is deemed to be made immediately after the original payment)
 - 43.5 **Tracing the property:** the onward payment must include either (i) the whole or part of the matched benefit, (ii) anything which derives from or represents that matched benefit or (iii) other property if the original payment is made with a view to enabling or facilitating the onward payment.
- 44. An additional requirement is that of matching. This links the amount of income arising to the Original Beneficiary to protected foreign income. This means that the rules can only apply to structures with protected foreign income.
 - 45. Again, the provisions will not apply if it can be shown that either there are no (i) arrangements (defined in loose terms) for or an intention as to the passing on of the original payment or (ii) that there is no reasonable expectation that the Subsequent Recipient will be resident in the UK when he receives at least part of what is being passed on.
 - 46. The Original Beneficiary is excluded from charge on so much of income as is treated as arising to a Subsequent Recipient. A similar exemption applies to any liability which a settlor would have in relation to close members of his family.
 - 47. There are not the same provisions for multiple onward gifts, although the possibility of an indirect gift remains.

Income treated as arising to Subsequent Recipient

- 48. If the Subsequent Recipient is UK resident and domiciled he will be liable to income tax in respect of the onward gift as if he were an individual to

whom income is treated as arising under section 732 ITA 2007. If he is a remittance basis taxpayer he will be liable to the extent it is remitted. (See section 733C ITA 2007).

Deemed income attributed to Subsequent Recipient

49. If the Subsequent Recipient is non-resident in the gift year or if later the matching year or if he is a remittance basis taxpayer in the charging year and none of the onward payment is remitted in that year, the onward gift rules apply to the Subsequent Recipient as if he were the Original Beneficiary (section 733D ITA 2007).

Settlor charge

50. Parallel provisions to the charge on the settlor where benefits provided to close members of his family apply where the Subsequent Recipient is a close member of the settlors family not within the immediate charge (section 733E ITA 2007).

AMENDMENT OF THE SETTLEMENTS CODE TO COVER ONWARD GIFTS

51. There is no equivalent under the settlements provisions to the charge which applies on a beneficiary receiving a benefit from a trust as applied under TCGA and ToAA. It was therefore necessary to make one up – which has been achieved with a charge on a settlor or close family members receiving protected foreign income.
52. That in turn gives scope for an onward gifts charge in relation to that limited beneficiary charge. A straightforward and parallel provision governing the situation where a beneficiary transfers on to a settlor or close members of his family section 643M and 643N ITTOIA 2005.
53. A measurably more complicated series of provisions apply where the onward gift is made by the settlor or a member of the settlor's close family to the settlor or another member of his close family (section 643I to 643L ITTOIA 2005).
54. The purposes of these provisions is not immediately obvious. One consequence, however, is that where the Subsequent Recipient is taxed on income by reference to a benefit the Original Beneficiary is relieved of liability.