REDUCING THE REVENUE'S INTEREST IN A SETTLEMENT

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The purpose of this article is to consider a possible way of avoiding the charge to capital gains tax (CGT) under section 77 of the Taxation of Chargeable Gains Act 1992 (charge on settlor with interest in settlement).

It will be recalled that, but for section 77, and subject to any future changes in the law following the Inland Revenue's Consultative Document on Trusts, the rate at which the trustees of a settlement are charged to CGT is 25% unless they are trustees of an "accumulation or discretionary settlement" in the year: sections 4 and 5 of the 1992 Act.

If an interest in possession subsists in all the settled property throughout the year, the settlement will not be an accumulation or discretionary settlement in the year, and so the rate of charge will, *prima facie* , be 25%. (Indeed, if an interest in possession subsists in part of the settled property in part of the year, the rate of charge will be 25% provided that income arises from that part of the property in that part of the year, and no other income arises during the year.)

However, section 77 provides that where at any time during the year the settlor of the settlement has an interest in the settlement, then an amount equal to the trustees' chargeable gains is treated as accruing to the settlor, and is accordingly taxable at his own rate of up to 40%. Section 78 gives the settlor a right to recover the tax paid by from the trustees, so that in effect the trustees are chargeable to CGT at the settlor's rate if the settlor has an interest in the settlement. For this purpose, subject to certain exceptions, the settlor is treated as having an interest in the settlement if any of the settled property or income "is, or will or may become, applicable for the benefit of or payable to the settlor or the spouse of the settlor in any circumstances whatsoever", or if "the settlor, or the spouse of the settlor, enjoys a benefit deriving directly or indirectly from any" of the settled property or income: section 77(3)(a) and(b).

It is important to note that section 77 only applies if the settlor has an interest, as defined, at any time during the year in which the gains accrue to the trustees. The fact that the settlor had an interest in an earlier year is irrelevant. Thus, there is no CGT disadvantage in making the settlor and his spouse beneficiaries of the settlement, provided that they can be excluded before the beginning of the year.

Of course, even though the trustees may have a power to exclude the settlor and his spouse, the settlor may not want them to exercise it. Indeed, the settlor may wish to benefit directly from the proceeds of sale of the trust assets. This article suggests a way nevertheless to avoid section 77.

Suppose it is 1st March. The trust assets are worth 100. The trustees' base cost (with indexation relief) is 10; therefore on a disposal chargeable gains of 90 will accrue, giving a CGT charge of up to 36 (if

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section 77 applies) or 22.5 (if it does not). Before the end of the year of assessment, the trustees borrow 75 (not from the settlor or his spouse). In exercise of their power, the trustees appoint the 75 to the settlor absolutely. Then, the trustees exercise their power to exclude the settlor and his spouse from any further benefit. On 6th April in the following year of assessment, they sell the trust assets. Section 77 will not apply to their gain because the settlor does not have an interest in the settlement in that year. The trustees will use the proceeds of sale to repay the loan of 75 and any interest, and to pay the CGT of 22.5.

An alternative to the trustees appointing the 75 to the settlor absolutely would be for them to pay it to the trustees of a new settlement of which the settlor is a beneficiary.

Could the Revenue attack these arrangements with the *Ramsay* principle? In my view they could not. There is nothing artificial about them. No step has been inserted to avoid tax. More vulnerable, perhaps, would be arrangements which begin with the settlor as the absolute owner of the asset, say shares in a trading company. The shares are pregnant with chargeable gains. He settles the shares upon interest in possession trusts, making a hold-over claim. Then the trustees borrow, appoint out the cash, exclude him from benefit, and sell the shares in the next year, all as above. If the cash is not appointed back to the settlor absolutely, but instead is paid over to the trustees of a new settlement, the Revenue would have to argue that the two settlements should be treated as a single settlement. But the definition of "settlement" for section 77 purposes is the normal, narrow, CGT one, rather than the wide income tax one which includes any arrangement. And if the new settlement is made weeks or months after the creation of the first, and has different trustees' etc., it would be difficult to say that in reality it was part of a single settlement.