

FINANCE ACT 2006 CAPITAL GAINS TAX AND INCOME TAX CHANGES: IMPACT ON NON-UK RESIDENT TRUSTS

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This article is loosely² based on my Key Haven Intelligence Report *The Taxation of Trusts Post Finance Act 2006*. References other than internal references are to that Report.

1 Non-Inheritance Tax Related Changes to the Capital Gains Tax Taxation of Settlements

1.1 Overview³

Finance Act 2006 section 88 and Schedule 12 and amended the Taxation of Chargeable Gains Act 1992 in various ways concerning the taxation of settlements. References in this article to Schedule 12 are, unless the context otherwise requires, to Schedule 12 to Finance Act 2006.

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² For obvious reasons, there is much in the Report not included in this article. Conversely, this article contains some material not contained in the Report which is of particular relevance to offshore and excluded property settlements.

³ In order to assist the reader I have *italicised* words added to statutory provisions by Finance Act 2006.

There are three new sections, 68A, 68B and 68C, which define “settlor”, unless the context otherwise requires.

The definition of a settlor-interested settlement for the purposes of the onshore settlor provisions (Taxation of Chargeable Gains Act 1992 sections 77—79) and the restrictions on (and clawbacks of) holdover relief on disposals of assets to the trustees of settlement has been extended to include a settlement under which a “dependent child” of the settlor can benefit. These changes, however, will be of no direct relevance to non-UK resident settlements.

There are new provisions regarding sub-fund settlements, of a complexity out of all proportion to their utility.

There is a number of “consequential and minor amendments”. Some of these are far from minor! Others are merely pedantic. The most important by far are those relating to the residence of trustees, discussed at 1.4.

In this article, I shall consider only what I consider to be the most important changes.

1.2 The Definition of “Settled Property”

Taxation of Chargeable Gains Act 1992 sections 68 and 60 now provide:

“68 Meaning of “settled property”

In this Act, unless the context otherwise requires, “settled property” means any property held in trust other than property to which section 60 applies (and references, however expressed, to property comprised in a settlement are references to settled property).”

“60 Nominees and bare trustees

- (1) In relation to *property* held by a person as nominee for another person, or as trustee for another person absolutely entitled as against the trustee, or for any person who would be so entitled but for being an infant or other person under disability (or for 2 or more persons who are or would be jointly so entitled), this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the *property* were the acts of, the person or persons for whom he is the nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly).
- (2) It is hereby declared that references in this Act to any [property]¹

held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the *property* for payment of duty, taxes, costs or other outgoings, to direct how that *property* shall be dealt with.”

While both sections 60 and 68 have been amended by Schedule 12, I cannot discern any difference of meaning.

While there is a definition of “settled property” there is no general definition of “settlement”. One surmises that a settlement exists wherever there is “settled property”.

1.3 The Definition of “Settlor”

1.3.1 General Comment

From 1965 until 2006, the capital gains tax legislation managed to survive without a definition of “settlor”! Now, Schedule 12 has inserted section 68A, 68B and 68C into the Taxation of Chargeable Gains Act 1992.

1.3.2 Taxation of Chargeable Gains Act 1992 Section 68A

1.3.2.1 The Statute

Taxation of Chargeable Gains Act 1992 section 68A (Meaning of “settlor”) provides:

“(1) *In this Act, unless the context otherwise requires —*

- (a) *"settlor" in relation to a settlement means the person, or any of the persons, who has made, or is treated for the purposes of this Act as having made, the settlement, and*
- (b) *a person is a settlor of property which —*
 - (i) *is settled property by reason of his having made the settlement (or by reason of an event which causes him to be treated under this Act as having made the settlement), or*
 - (ii) *derives from property to which sub-paragraph (i) applies.*

- (2) *A person is treated for the purposes of this Act as having made a settlement if —*
- (a) *he has made or entered into the settlement, directly or indirectly, or*
 - (b) *the settled property, or property from which the settled property is derived, is or includes property of which he was competent to dispose immediately before his death, and the settlement arose on his death, whether by will, on his intestacy, or otherwise.*
- (3) *A person is, in particular, treated for the purposes of this Act as having made a settlement if —*
- (a) *he has provided property directly or indirectly for the purposes of the settlement, or*
 - (b) *he has undertaken to provide property directly or indirectly for the purposes of the settlement.*
- (4) *Where one person (A) makes or enters into a settlement in accordance with reciprocal arrangements with another person (B), for the purposes of this Act —*
- (a) *B shall be treated as having made the settlement, and*
 - (b) *A shall not be treated as having made the settlement by reason only of the reciprocal arrangements.*
- (5) *In subsection (2)(b) "property of which he was competent to dispose immediately before his death" shall be construed in accordance with section 62(10) (reading each reference to "assets" as a reference to "property").*
- (6) *A person who has been a settlor in relation to a settlement shall be treated for the purposes of this Act as having ceased to be a settlor in relation to the settlement if —*
- (a) *no property of which he is a settlor is comprised in the settlement,*
 - (b) *he has not undertaken to provide property directly or indirectly for the purposes of the settlement in the future,*

and

- (c) he has not made reciprocal arrangements with another person for that other person to enter into the settlement in the future.*
- (7) For the purpose of this section and sections 68B and 68C property is derived from other property —*
 - (a) if it derives (directly or indirectly and wholly or partly) from that property or any part of it, and*
 - (b) in particular, if it derives (directly or indirectly and wholly or partly) from income from that property or any part of it.*
- (8) In this section "arrangements" includes any scheme, agreement or understanding, whether or not legally enforceable."*

1.3.2.3 Comment

Most of this is very straightforward.

It would appear on a literal reading that a person can be a “settlor” if he has “made” the settlement and is the settlor of property which is settled property by reason of his having “made” the settlement. Read literally, this would include the initial trustees, yet that can hardly have been intended.

The concept of indirect settlors is far from being a new concept in tax law.

That a person should be able to make a settlement by will is hardly surprising. Where a settlement arises on an intestacy, the deceased is deemed to be the settlor.

The provisions relating to reciprocal settlors resemble thus in the Income Tax (Trading and Other Income) Act 2005 Settlement Provisions (sections 620 and following).

It will be recalled that under the basic definition, there must be a trust in order to constitute a settlement and an “arrangement” which does not amount to a trust will not, for this purpose, constitute a “settlement”. Section 68A(8) does not alter this requirement. It merely applies for the purposes of section 68A(4) and (6) in relation to reciprocal settlements.

1.3.3 Taxation of Chargeable Gains Act 1992 Section 68B

1.3.3.1 The Statute

“68B Transfer between settlements: identification of settlor

(1) This section applies in relation to a transfer of property from the trustees of one settlement ("Settlement 1") to the trustees of another ("Settlement 2") otherwise than —

- (a) for full consideration, or*
- (b) by way of a bargain made at arm's length.*

(2) In this section "transfer of property" means —

- (a) a disposal of property by the trustees of Settlement 1, and*
- (b) the acquisition by the trustees of Settlement 2 of —*
 - (i) property disposed of by the trustees of Settlement 1, or*
 - (ii) property created by the disposal;*

and a reference to transferred property is a reference to property acquired by the trustees of Settlement 2 on the disposal.

(3) For the purposes of this Act, except where the context otherwise requires—

- (a) the settlor (or each settlor) of the property disposed of by the trustees of Settlement 1 shall be treated from the time of the disposal as having made Settlement 2, and*
- (b) if there is more than one settlor of the property disposed of by the trustees of Settlement 1, each settlor shall be treated in relation to Settlement 2 as the settlor of a proportionate part of the transferred property.*

(4) For the purposes of this Act, except where the context otherwise requires, if and to the extent that the property disposed of by the trustees of Settlement 1 was provided for the purposes of Settlement 1, or is derived from property provided for the purposes of

Settlement 1, the transferred property shall be treated from the time of the disposal as having been provided for the purposes of Settlement 2.

- (5) *If transferred property is treated by virtue of subsection (4) as having been provided for the purposes of Settlement 2 —*
 - (a) *the person who provided the property disposed of by the trustees of Settlement 1, or property from which it was derived, for the purposes of Settlement 1 shall be treated as having provided the transferred property, and*
 - (b) *if more than one person provided the property disposed of by the trustees of Settlement 1, or property from which it was derived, for the purposes of Settlement 1, each of them shall be treated as having provided a proportionate part of the transferred property.*
- (6) *But subsections (3) and (4) do not apply in relation to a transfer of property —*
 - (a) *which occurs by reason only of the assignment or assignation by a beneficiary under Settlement 1 of an interest in that settlement to the trustees of Settlement 2,*
 - (b) *which occurs by reason only of the exercise of a general power of appointment, or*
 - (c) *to which section 68C(6) applies.*
- (7) *In determining whether this section applies in relation to a transfer of property between settlements, section 18(2) shall be disregarded.”*

1.3.3.2 Comment

The section probably adds makes little, if any, difference, to the interpretation of the capital gains tax legislation.

1.3.2 Taxation of Chargeable Gains Act 1992 section 68C

1.3.4.1 The Statute

“68C *Variation of will or intestacy, etc: identification of settlor*

- (1) *This section applies where —*
 - (a) *a disposition of property following a person's death is varied, and*
 - (b) *section 62(6) applies in respect of the variation.*
- (2) *Where property becomes settled property in consequence of the variation (and would not, but for the variation, have become settled property), a person mentioned in subsection (3) shall be treated for the purposes of this Act, except where the context otherwise requires —*
 - (a) *as having made the settlement, and*
 - (b) *as having provided the property for the purposes of the settlement.*
- (3) *Those persons are —*
 - (a) *a person who immediately before the variation was entitled to the property, or to property from which it derives, absolutely as legatee,*
 - (b) *a person who would have become entitled to the property, or to property from which it derives, absolutely as legatee but for the variation,*
 - (c) *a person who immediately before the variation would have been entitled to the property, or to property from which it derives, absolutely as legatee but for being an infant or other person under a disability, and*
 - (d) *a person who would, but for the variation, have become entitled to the property, or to property from which it derives, absolutely as legatee if he had not been an infant or other person under a disability.*
- (4) *In subsection (3) references to a person being entitled to property absolutely as legatee shall be construed in accordance with section 64(3) (reading the references to "an asset" and "any asset" as references to "property").*
- (5) *Where —*

- (a) *property would have become comprised in a settlement—*
 - (i) *which arose on the deceased person's death (whether in accordance with his will, on his intestacy or otherwise), or*
 - (ii) *which was already in existence on the deceased person's death (whether or not the deceased person was a settlor in relation to that settlement), but*
- (b) *in consequence of the variation the property, or property derived from it, becomes comprised in another settlement,*

the deceased person shall be treated for the purposes of this Act, except where the context otherwise requires, as having made the other settlement.

(6) *Where—*

- (a) *immediately before the variation property is comprised in a settlement and is property of which the deceased person is a settlor, and*
- (b) *immediately after the variation the property, or property derived from it, becomes comprised in another settlement,*

the deceased person shall be treated for the purposes of this Act, except where the context otherwise requires, as having made the other settlement.

- (7) *If a person is treated as having made a settlement under subsection (5) or (6), for the purposes of this Act he shall be treated as having made the settlement immediately before his death.*
- (8) *But subsection (7) does not apply in relation to a settlement which arose on the person's death.”*

1.3.4.2 Comment

Taxation of Chargeable Gains Act 1992 section 62(6) provides:

- “(6) Subject to subsections (7) and (8) below, where within the period of 2 years after a person's death any of the dispositions (whether

effected by will, under the law relating to intestacy or otherwise) of the property of which he was competent to dispose are varied, or the benefit conferred by any of those dispositions is disclaimed, by an instrument in writing made by the persons or any of the persons who benefit or would benefit under the dispositions—

- (a) the variation or disclaimer shall not constitute a disposal for the purposes of this Act, and
- (b) this section shall apply as if the variation had been effected by the deceased or, as the case may be, the disclaimed benefit had never been conferred.”

Prior to Finance Act 2006, the question who was the settlor of a settlement created by a section 62(6) variation was extremely interesting. The House of Lords decision in *Marshall v Kerr* [1994] STC 638 established that in the case where the estate was governed by English law and what was settled was an absolute interest in residue and that was done during the period of administration, then the settlor for capital gains tax purposes was the residuary legatee and not the testator. However, the view I took was that, where the estate was fully administered before the variation or the estate was governed by the provisions of some foreign law or what was settled was not an interest in residue, then the position could be quite different.

It seems to me that the intent of section 68C is to extend the scope of *Marshall v Kerr* to all cases where a person absolutely entitled to non-settled property comprised in an estate enters into a section 62(6) variation which creates a settlement.

Where, however, the property is already settled by will (or on an intestacy), then the intention is no doubt that if the variation results in the settled property becoming comprised in another settlement, it is still the testator (or deceased) who is treated as being the only settlor. It is a moot point whether, if the settlement is not completely constituted by the time of the variation, section 68C(5) could apply. In my view, it would, otherwise the subsection would in general be deprived of any content. Yet the contrary is not unarguable.

What is surprising about the section is what is not said. What if immediately before the variation property is comprised in a settlement and is property of which the deceased person is a settlor, and immediately after the variation the property, or property derived from it, remains comprised in the same settlement? The case is not expressly dealt with. In my view, one can only assume that the deceased is regarded as being the only settlor. The same applies if the case is not within subsection (6) but within subsection (5).

The assumption underlying the section is that where the terms of any settlement are varied by the beneficiaries, then there is no change in the settlor and in particular the parties to the variation do not become settlors. While that is probably the general rule, one can imagine exceptional cases where that might not be the case.

1.3.5 Limited Applications of Sections 68A—68C.

Oddly enough, section 68A—68C do not apply in some of the most important contexts!

For the purposes of the Offshore Settlor Provisions (contained principally in Taxation of Chargeable Gains Act 1992 section 86), the definition of “settlor” is to be found in Schedule 5 to the Taxation of Chargeable Gains Act 1992.

For the purposes of the Offshore Beneficiary Provisions (contained principally in Taxation of Chargeable Gains Act 1992 sections 87—98A), the definition of “settlement” is not the normal capital gains tax one but that contained in the income tax Settlement Provisions (Income Tax (Trading and other Income) Act 2005 Part 5 Chapter 5), as is the definition of “settlor”.

1.4 Trustees: Artificial Person and Residence

1.4.1 The Statute

Taxation of Chargeable Gains Act 1992 section 69(1) and (2) are being amended, partially with effect only from 6th April 2007. They will provide:

- "(1) For the purposes of this Act the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are trustees of the settlement from time to time).*
- (2) The deemed person referred to in subsection (1) shall be treated for the purposes of this Act as resident and ordinarily resident in the United Kingdom at any time when a condition in subsection (2A) or (2B) is satisfied.*
- (2A) Condition 1 is that all the trustees are resident in the United Kingdom.*
- (2B) Condition 2 is that—*
 - (a) at least one trustee is resident in the United Kingdom,*

- (b) *at least one is not resident in the United Kingdom, and*
 - (c) *a settlor in relation to the settlement was resident, ordinarily resident or domiciled in the United Kingdom at a time which is a relevant time in relation to him.*
- (2C) *In subsection (2B)(c) "relevant time" in relation to a settlor—*
- (a) *means, where the settlement arose on the settlor's death (whether by will, intestacy or otherwise), the time immediately before his death, and*
 - (b) *in any other case, means a time when the settlor made the settlement (or was treated for the purposes of this Act as making the settlement);*
- and, in the case of a transfer of property from Settlement 1 to Settlement 2 in relation to which section 68B applies, "relevant time" in relation to a settlor of the transferred property in respect of Settlement 2 includes any time which, immediately before the time of the disposal by the trustees of Settlement 1, was a relevant time in relation to that settlor in respect of Settlement 1.*
- (2D) *A trustee who is not resident in the United Kingdom shall be treated for the purposes of subsections (2A) and (2B) as if he were resident in the United Kingdom at any time when he acts as trustee in the course of a business which he carries on in the United Kingdom through a branch, agency or permanent establishment there.*
- (2E) *If the deemed person referred to in subsection (1) is not treated for the purposes of this Act as resident and ordinarily resident in the United Kingdom, then for the purposes of this Act it shall be treated as neither resident nor ordinarily resident in the United Kingdom."*

1.4.2 Effective Date of Amendments

The amendments made to section 69(1) and (2) have effect—

- “(a) for the purposes of determining the residence status of the trustees of a settlement (whenever created), from 6th April 2007, and

- (b) for any other purpose (in relation to settlements whenever created), from 6th April 2006.”

See Schedule 12 paragraph 2(2).

1.4.3 Trustees as a Single Person

Although the wording of the new section 69(1) is different, I do not myself see that the amendments makes any difference of substance. (The wording of the present section 69(1) is set out at 1.4.4.1.)

1.4.4 The New Residence Test

1.4.4.1 General Comment

The new residence test is similar to that which formerly applied for income tax purposes and which was contained in Finance Act 1989 section 110. It differs considerably from the current capital gains tax test, which is:

“69 Trustees of settlements

- (1) In relation to settled property, the trustees of the settlement shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the trustees), and that body shall be treated as being resident and ordinarily resident in the United Kingdom unless the general administration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or a majority of them for the time being are not resident or not ordinarily resident in the United Kingdom.
- “(2) Notwithstanding subsection (1) above, a person carrying on a business which consists of or includes the management of trusts, and acting as trustee of a trust in the course of that business, shall be treated in relation to that trust as not resident in the United Kingdom if the whole of the settled property consists of or derives from property provided by a person not at the time (or, in the case of a trust arising under a testamentary disposition or on an intestacy or partial intestacy, at his death) domiciled, resident or ordinarily resident in the United Kingdom, and if in such a case the trustees or a majority of them are or are treated in relation to that trust as not resident in the United Kingdom, the general administration of the trust shall be treated as ordinarily carried on outside the United Kingdom.”

1.4.4.2 Place of General Administration of the Trusts

Under the new test, it is irrelevant where the general administration of the trusts is ordinarily carried on. This will assist considerably in ensuring that a trust is non-UK resident where the at least part of the administration of the trust is carried on in the United Kingdom, whether by the trustees or by their agents.

Under many double taxation conventions, if the trustees of a settlement are dual resident, they will be deemed to be a resident of the Contracting State in which the effective management of the trust is carried on. That, however, is a rather different concept from the place of general administration. This is not affected by Finance Act 2006.

1.4.4.3 Mixed Residence Trusts

Under the present law, subject to the special rule contained in section 69(2), one asks simply whether a majority of the trustees is resident outside of the United Kingdom. If they are not, the trust is United Kingdom resident. If they are, the trust is non-UK resident, unless it falls foul of the place of general administration of the trusts test.

Where no settlor was at any material time domiciled, resident and ordinarily resident in the United Kingdom, a professional trustee is regarded as United Kingdom resident. This rule completely disappears under the new law.

Under the new law, if there is more than one trustee and at least one of them is United Kingdom resident, the trustees are treated as United Kingdom resident unless no settlor was at any material time domiciled, resident and ordinarily resident in the United Kingdom, in which case they are treated as non-UK resident.

1.4.4.4 Trustee Carrying on Business in the United Kingdom

If a trustee is not in fact United Kingdom resident, then it does not matter that he acts as trustee in the course of a business which he carries on in the United Kingdom through a branch, agency or permanent establishment here. Of course, if he is the sole trustee, then it may well be that the general administration of the trust is carried on in the United Kingdom and the trustees are treated as United Kingdom resident on that account.

Under the new law, for the purposes of ascertaining the residence of the single artificial person the trustees of a settlement are deemed to be, a trustee who is not resident in the United Kingdom will be treated as if he were resident in the United Kingdom at any time when he acts as trustee in the course of a business which he

carries on in the United Kingdom through a branch, agency or permanent establishment here.

1.4.4.5 Transitional Provisions and Advance Planning

It was at one stage suggested that there would be transitional provisions affecting the new residence rules. In fact, there are no transitional provisions as such. The application of the new rules has merely been deferred until 6th April 2007. The result is that it will be extremely important to check in advance the effect of the change of the law on each settlement the residence status of which might conceivably be affected. In the remainder of this section, I consider a few examples.

Example 1 – Non-UK Resident Trust with Sole United Kingdom Resident Professional Trustee

A settlement with a sole United Kingdom resident professional trustee may currently be regarded as non-UK resident by virtue of the present section 69(2). As from 6th April 2007, it nothing is done it will become United Kingdom resident.

Example 2 – Non-UK Resident Trust with Majority of Non-UK Resident Trustees

A settlement with a majority of non-UK resident trustees will be non-UK resident at present, provided the general administration of the trusts is ordinarily carried on outside the United Kingdom. As from 6th April 2007, the trustees will be regarded as United Kingdom resident if any settlor was at any material time domiciled, resident or ordinarily resident in the United Kingdom.

Example 3 – United Kingdom Resident Trust with No Majority of Trustees Resident Outside of the United Kingdom

A settlement which does not have a majority of trustees who are neither in reality nor deemed, by section 69(2), to be resident outside of the United Kingdom will currently be United Kingdom resident. If on 6th April 2007 it still has at least one non-UK resident trustee and there is no settlor who was at any material time domiciled, resident or ordinarily resident in the United Kingdom, then the trustees will be regarded as non-UK resident.

Example 4 – United Kingdom Resident Trust with Non-UK Resident Trustees but the General Administration of the Trust Ordinary Carried on in the United Kingdom

Even a settlement all the of trustees of which are not resident in the United Kingdom will currently be United Kingdom resident if the general administration of the trust is ordinary carried on in the United Kingdom (and it is not deemed by section 69(2) not to be so carried on). As from 6th April 2007, the place of general administration will be irrelevant, so that such a trust would become non-UK resident. Even such a trust which has trustees of mixed residence could still become non-UK resident.

1.4.4.6 Consequences of Change of Residence

The consequences of a change of the residence status of the trustees of a settlement has not been altered by Finance Act 2006. I shall recall the most important.

If the trustees become non-UK resident:

- they will normally be deemed to dispose of all the settled property for a market value consideration
- the beneficial interests will all become (if not already) chargeable assets
- there may well be a tax-free uplift in the base cost of the beneficial interests

These consequences follow even if the trust becomes United Kingdom resident once more in the same year of assessment, so that the trustees are at all times within the charge to capital gains tax.

If the trustees become United Kingdom resident, they will come within the charge to capital gains tax. If they subsequently emigrate:

- they will normally be deemed to dispose of all the settled property for a market value consideration
- there may be a tax-free uplift in the base cost of the beneficial interests.

These consequences follow even if the trust becomes non-UK resident once more in the same year of assessment.

1.5 The Onshore Settlor Provisions

1.5.1 Introduction

Prior to Finance Act 2006, the onshore settlor provisions would apply only if the settlor or his spouse could benefit or did in fact benefit under a settlement. The provisions have now been extended to the case where there is in existence a dependent child of the settlor who can benefit.

Some other changes have also been made to the Provisions.

1.5.2 The Statute

Taxation of Chargeable Gains Act 1992 section 77 (Charge on settlor with interest in settlement) now provides:

“77

(1) Where in a year of assessment—

- (a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
- (b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would be chargeable to tax for the year in respect of those gains if—
 - (i) the gains were not eligible for taper relief, but section 2(2) applied as if they were (so that the order of deducting losses provided for by section 2A(6) applied), and
 - (ii) section 3 were disregarded,

and

- (c) at any time during the year the settlor has an interest in the settlement,

the trustees shall not be chargeable to tax in respect of those *gains* but instead chargeable gains of an amount equal to that referred to in paragraph (b) shall be treated as accruing to the settlor in that year.

- (2) Subject to the following provisions of this section, a settlor shall be regarded as having an interest in a settlement if—
 - (a) any property which *is or* may at any time be comprised in the settlement, or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse or civil partner in any circumstances whatsoever, or
 - (b) the settlor or his spouse or civil partner enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.
- (2A) *A settlor shall also be regarded as having an interest in a settlement (subject to the following provisions of this section) if—*
 - (a) *any property which is or may at any time be comprised in the settlement, or any derived property, is, or will or may become, payable to or applicable for the benefit of a child of the settlor, at a time when that child is a dependent child of his, in any circumstances whatsoever, or*
 - (b) *a dependent child of the settlor enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.*
- (3) The references in subsection (2)(a) and (b) above to the spouse or civil partner of the settlor do not include—
 - (a) a person to whom the settlor is not for the time being married but may later marry, or
 - (b) a person of whom the settlor is not for the time being a civil partner but of whom he may later be a civil partner, or
 - (c) a spouse or civil partner from whom the settlor is separated under an order of a court, or under a separation agreement or in such circumstances that the separation is likely to be permanent, or
 - (d) the widow or widower or surviving civil partner of the settlor.

(3A) *In this section—*

(a) *“dependent child” means a child who—*

(i) *is under the age of 18 years,*

(ii) *is unmarried, and*

(iii) *does not have a civil partner, and*

(b) *“child” includes a stepchild.*

(3B) *For the purposes of subsection (2A) above no account shall be taken of a term of a settlement relating to dependent children of a settlor in respect of any time at which he has no dependent child.*

(4) A settlor shall not be regarded as having an interest in a settlement by virtue of subsection (2)(a) above if and so long as none of the property which may at any time be comprised in the settlement, and no derived property, can become payable or applicable as mentioned in that provision except in the event of—

(a) the bankruptcy of some person who is or may become beneficially entitled to the property or any derived property, or

(b) an assignment of or charge on the property or any derived property being made or given by some such person, or

(c) in the case of a marriage settlement or civil partnership settlement, the death of both parties to the marriage or civil partnership and of all or any of the children of the family of the parties to the marriage or civil partnership, or

(d) the death of a child of the settlor who had become beneficially entitled to the property or any derived property at an age not exceeding 25.

(4A) In subsection (4) “child of the family”, in relation to parties to a marriage or civil partnership, means a child of one or both of them.

(5) A settlor shall not be regarded as having an interest in a settlement

by virtue of subsection (2)(a) above if and so long as some person is alive and under the age of 25 during whose life the property or any derived property cannot become payable or applicable as mentioned in that provision except in the event of that person becoming bankrupt or assigning or charging his interest in that property.

- (6) This section does not apply—
- (a) where the settlor dies during the year;
 - (b) in a case where the settlor is regarded as having an interest in the settlement by reason only of—
 - (i) the fact that property is, or will or may become, payable to or applicable for the benefit of his spouse or civil partner, or
 - (ii) the fact that a benefit is enjoyed by his spouse or civil partner, where the spouse or civil partner dies, or the settlor and the spouse or civil partner cease to be married or to be civil partners of each other, during the year; or
 - (c) *in a case where the settlor is regarded as having an interest in a settlement by reason only of—*
 - (i) *the fact that property is, or will or may become, payable to or applicable for the benefit of a dependent child of his, or*
 - (ii) *the fact that a benefit is enjoyed by such a child,*

where the settlor ceases during the year to have (and does not in that year subsequently come to have) any dependent child in relation to whom subsection (2A)(a) or (b) above applies.
- (7) This section does not apply unless the settlor is, and the trustees are, either resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year.
- (8) *In this section "derived property", in relation to any property, means—*

- (a) *income from that property,*
 - (b) *property directly or indirectly representing—*
 - (i) *proceeds of that property, or*
 - (ii) *proceeds of income from that property, or*
 - (c) *income from property which is derived property by virtue of paragraph (b) above.*
- (9) *This section shall have effect subject to the provisions of section 30 of the Finance Act 2005.”*

1.5.3 Commentary

The specious reason given why a settlement should become “settlor interested” if a dependent child of the settlor can or does benefit under it was uniformity with the income tax settlement provisions, contained in Income Tax (Trading and other Income) Act 2005 Part 5 Chapter 5. Yet those provisions, in particular Income Tax (Trading and other Income) Act 2005 section 629 are much more limited in their scope! One has to ask once more whether the Revenue are really that ignorant or whether the reason given is just more spin.

The fact that a dependent child of the settlor can benefit in future does not bring the section into play unless and until there is such a child in existence.

The word “gains” has been inserted in subsection (1) to correct a simple drafting error.

The former subsection (8) provided:

- “(8) In this section “derived property”, in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income therefrom.”

That has now been made somewhat clearer.

Subsection (9) is new. Finance Act 2005 section 30 is part of the special regime for qualifying trusts for vulnerable persons.

1.6 Restriction of Holdover Relief

Taxation of Chargeable Gains Act 1992 section 169B to 169G restrict holdover relief under Taxation of Chargeable Gains Act 1992 sections 165 and 260 in the case of a disposal to the trustees of a settlor-interested settlement. Section 169F (Meaning of “interest in a settlement” in sections 169B to 169D) has been amended by, *inter alia*, the addition of a new subsection (3A), which provides:

“(3A) *This subsection applies if—*

- (a) *any property which is or may at any time be comprised in the settlement, or any derived property, is, or will or may become, payable to or applicable for the benefit of a child of the individual, at a time when that child is a dependent child of his, in any circumstances whatsoever, or*
- (b) *a dependent child of the individual enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.”*

This extension parallels that to Taxation of Chargeable Gains Act 1992 section 77. The same definitions are adopted.

Taxation of Chargeable Gains Act 1992 section 169C imposes a clawback charge where holdover relief is given on a disposal to the trustees of a settlement and the settlement subsequently becomes settlor interested. If a disposal was made before 6th April 2006 to a settlement which on that date becomes settlor-interested because of the change in the law, is there then a clawback charge? There is not. See Finance Act 2006 Schedule 12 paragraph 4(3).

1.7 Sub-Funds

Schedule 12 inserts a new Schedule 4ZA into the Taxation of Chargeable Gains Act 1992 headed “Sub-fund Settlements”. Subject to stringent conditions, the trustees of a settlement (the “principal settlement”) may elect that a fund or other specified portion of the settled property (the “sub-fund”) be treated, in general, as a separate settlement (the “sub-fund settlement”) for the purposes of this Taxation of Chargeable Gains Act 1992.

These are provisions which in my view are of a complexity which is likely to be out of all proportion to their utility. In the vast majority of cases, the trustees of a settlement always were (and still are) able to ensure that a sub-fund of the settlement was treated for capital gains tax purposes as contained in a separate settlement by ensuring that it was held on the trusts of a separate settlement (for

capital gains tax purposes). I have not myself perceived any advantage of bringing one existing settlement within Schedule 4ZA, which is not to say that there may not be some. Schedule 4ZA will be useful principally in those, probably limited, cases where it is not possible as a matter of trust law to hive off part of the trust assets to the trustees of a separate settlement.

There is much learning on when a settlement is a separate settlement for capital gains tax purposes, which is unaffected by Finance Act 2006.

2 Changes to the Income Tax Taxation of Settlements

2.1 Overview

Finance Act 2006 section 89 and Schedule 13 have amended and amplified the income tax provisions relating to settlements contained in Income and Corporation Taxes Act 1988 and Income Tax (Trading and Other Income) Act 2005. The principal effect of some of these changes is simply to make the legislation longer.

The changes are the result of a long period of consultation between the Revenue and the public, especially the professional bodies. What has finally been enacted is very different from the original proposals. If only Gordon Brown had engaged in a similar consultation regarding the inheritance tax changes introduced by Finance Act 2006, they would either have taken a very different form or not been introduced at all.

There is now for the first time a general definition of “settled property”, contained in a new Income and Corporation Taxes Act 1988 section 685A, and a general definition of “settlor”, contained in new sections Income and Corporation Taxes Act 1988 sections 685B, 685C and 685D. There is no general definition of “settlement”.

There is an important new section 685E, which treats the trustees of a settlement as a single person, distinct from the persons who happen to be trustees, and laying down rules for the residence status of that person. This section may well have some unintended consequences.

There is a modest extension of the categories of income which are chargeable to tax at the section 686 rate, i.e., either the dividend trust rate (DTR) or the rate applicable to trusts (RAT), depending on the type of income.

The Income Tax (Trading and Other Income) Act 2005 settlement provisions (“the Income Tax Settlement Provisions”) used to convert income taxable on the settlor by virtue of those provisions into income taxable under Schedule D Case VI, no matter under which Schedule or Case it would have been taxable had the

provisions not applied. It will now, more logically, retain its original nature.

The Income Tax Settlement Provisions have been further amended to avoid a possible case of double taxation.

There is also a large number of “Minor and Consequential Amendments”. As we know from the decision of the House of Lords in *West v Trennery* [2005] UKHL5 [2005] STC 214, changes which are so described may be anything but minor or consequential.

Perhaps the most significant omission is the decision to leave Income and Corporation Taxes Act 1988 section 686 in place, albeit with extended effect, and not to tax all taxable income of non-interest in possession trusts at the section 686 rate. One result of this is that dividend income of non-interest in possession trust which is distributed can still be taxed at an unfairly high rate.

In this article, I discuss only some of the more important changes.

2.2 “Settled Property”

The new Income and Corporation Taxes Act 1988 section 685A (Meaning of “settled property”) provides:

- “(1) *For the purposes of the Tax Acts, unless the context otherwise requires,*
- (a) *“settled property” means any property held in trust other than—*
- (i) *property held by a person as nominee for another,*
- (ii) *property held by a person as trustee for another person who is absolutely entitled as against the trustee, and*
- (iii) *property held by a person as trustee for another person who would be absolutely entitled as against the trustee if he were not an infant or otherwise under a disability, and*
- (b) *references, however expressed, to property comprised in a settlement are references to settled property.*

- (2) *For the purposes of the Tax Acts, a reference to a person who is or would be absolutely entitled to property as against the trustee—*
- (a) *means a person who has the exclusive right (subject to satisfying the right of the trustees to resort to the property for the payment of duty, taxes, costs or other outgoings) to direct how the property shall be dealt with, and*
- (b) *includes two or more persons who are or would be jointly absolutely entitled as against the trustee.”*

This definition is identical to the new capital gains tax definition, which in turn does not differ in substance from the old capital gains tax definition. See 1.2.

A note of caution: while the expression “settled property” is one which is used extensively in the capital gains tax legislation, it is used far less in the income tax legislation.

There is still no general definition of “settlement”. We are merely told that references to “property comprised in a settlement” are to be construed as references to settled property. The definition in Income Tax (Trading and other Income) Act 2005 section 620 applies only for Part 5 Chapter 5 of that Act (the Income Tax Settlement Provisions), as does the definition of “settlement” contained in the same section.

2.3 Definition of “Settlor”

The new Income and Corporation Taxes Act 1988 sections 685B—685D are in identical terms, *mutatis mutandis*, to the new Taxation of Chargeable Gains Act 1992 sections 68A, 68B and 68C. See 1.3.

2.4 Trustees: Artificial Person and Residence

The new Income and Corporation Taxes Act 1988 section 685E (Trustees of settlements) is in identical terms, *mutatis mutandis*, to the amended Taxation of Chargeable Gains Act 1992 section 69. See 1.4. Section 685E does not come into force until 6th April 2007.

The new section 685E(1) provides that for the purposes of the Tax Acts the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person. It does not provide that any other person shall be treated as though the trustees of a settlement were a single person. That is, it does not provide that for the purposes of the Tax Acts the trustees shall be deemed to be a single person. In the context of the capital gains tax legislation,

this does not normally matter, as there are other important provisions dealing with, for example, gifts in settlement and persons becoming absolutely entitled to settled property as against the trustees of a settlement. In the context of income tax, however, there are no such other provisions.

2.5 Sub-Funds

An election can be made in certain circumstances under the new Taxation of Chargeable Gains Act 1992 Schedule 4ZA that a fund or other specified portion of the settled property (the “sub-fund”) be treated, in general, as a separate settlement (the “sub-fund settlement”) for the purposes of this Taxation of Chargeable Gains Act 1992.

Where such an election is made, the same consequences follow for income tax purposes. See the new Income and Corporation Taxes Act 1988 section 685G (Sub-funds).