The Offshore Tax Planning Review

TRUSTS OR COMPANIES: A COMPARATIVE ANALYSIS AND RELATED TAX AND TAX PLANNING

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Preliminary Comments

As practitioners in the related fields of trust law and estate law, we tend to reject the idea that the objectives implicit in trust and estate planning can jurisprudentially be achieved by the use of Anglo-Saxon legal concepts in the field of company law. The principal obstacle in trust and estate planning - the incidence of death in its effect on succession to property - whether it be land, shares, assets or money - is immediately absent when one views succession matters in the context of a company, which does not "die" except when its death is created by artificial means - liquidation or dissolution. And once it is borne in mind that interests in a company can be rendered permanent or transient, either by being rendered proprietary or personal, it can be seen that the incorporation concept can be used to achieve trust objectives - provided, that is, you can find a way to articulate it.

There is an explanation for this rejection. It is that historically the concept of incorporation springs from the notion that social rights are traditionally related to the individual and his family group, whereas business rights are related to the individual as sole trader or to groups of two or more individuals trading or carrying on business in association. In all civilised communities the business associations have evolved into syndicates or partnerships, which have, as the members in business groups have increased, also grown in size to the point when the number of constituents have made them unwieldy, driving their principals to seek some medium whereby the business group can carry on its commercial activity under a single composite label. This label came to be known as a company, the first use of it being as part of a partnership name - such as "Snooks

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and Company" where the "and Company", or "and Co." for short, was used to embrace those associates of Snooks who were willing to be engaged in the business activity without their individual names forming part of the business title. But the point here is that the "company" name evolved in an exclusively business context. It did not evolve from a social or family origin, so that traditionally it is not identified with social or family matters. History also shows that the concept of limited liability did not derive from social or family origins, but from business requirements.

It is not the purpose of this paper to summarise, let alone explain, how the concept arose, save to say that in the context of English business history, its evolution was held back for over 100 years by the South Sea Bubble financial scandal which led to the prohibition, by the Bubble Act of 1720, of all forms of corporation apart from those created by Royal Charter or Act of Parliament. Long after the Bubble memory had faded, business leaders wishing to find an abbreviated medium through which to carry on business on behalf of large groups of members, were frustrated by the prohibition from encouraging even incorporated status, let alone limited liability. These prejudices were circumvented by purloining from ecclesiastical sources the trust concept and using it to create what became known as the deed of settlement company. Such companies grew in volume from the end of the eighteenth century until the 1850s by which time, the Bubble Act having been repealed in 1825, it had begun to be appreciated that there was little practical difference between a single incorporated company and a single company constituted by a deed of settlement. This was first recognised in the first Companies Act of England which was passed through Parliament in 1844 as the Joint Stock Companies Act of that year. The evolution of limited liability coupled with the change from a deed of settlement to a memorandum and articles of association first came with the Limited Liability Companies Act 1855 and amending Act of the following year (1856). The first consolidation was effected in the Companies Act 1862, and further Companies Acts followed thereafter as we all know.

Comparisons Between Deeds of Settlement and Deed of Settlement Companies

It is interesting to compare deeds of settlement with the principal features of the deed of settlement company concept:

1. The deed of settlement comprising the foundation was made between a number of persons providing funds or assets (who were in the nature of settlors) and one or more trustee persons - who after 1855 became the company;

2. The fund or asset providers covenanted with the trustees to observe and perform the various provisions of the deed of settlement (which later

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became the articles of association) regulating the proportions (or shares) of the providers and the rights among themselves;

3. The deed of settlement commonly declared that the shareholders or members having rights over the subscribed capital should comprise a company with a specified name, objects, capital and specified basis for dissolution - this section of the deed later became the memorandum of association;

4. The deed often made the shares or members' rights transferable;

5. Management of the enterprise was generally vested in a selected number of the fund providers or shareholders or members, sometimes known as a committee or board of management, later as a board of directors;

6. The settled or transferred property was usually vested in the directors or some of them as trustees for the shareholders or members. Later, when the company replaced the trustees there evolved the view that the property was vested in the company to exploit it for the shareholders or members but not as trustees for them. This view was ultimately upheld by the House of Lords in 1917 (*Bowman v Secular Society* [1917] AC 406).

Evolution of the Guarantee Company Without Share Capital from the Deed of Settlement

So one can discern in the initial deed of settlement company format a simple form of bare trust with embellishments, with essentially the trustees - later the company - holding the transferred assets on behalf of the asset transferors who are co-owners or shareholders in it but who have no legal ownership of the assets themselves. No doubt this analogy led both to the company format and - where the format was not clothed with a veil of incorporation - to the unit trust or syndicate. But there also evolved the idea of a trust, later a company, where funds were not paid or transferred at inception but instead were the subject of commitments to provide them at the end of the life of the trust or company. This form of commitment was the guarantee; and when accompanied by incorporation status and limited liability, led to the evolution of the company limited by guarantee. If there were no funds required to enable the company to operate then the company was evolved to have effect without capital; but in cases where some capital might be required from some, but not other, guarantee members the company evolved as a company limited by guarantee with a share capital. These concepts, it must be appreciated, evolved at a period in history when it was not the custom to raise capital by borrowing or other temporary financial methods. In the eighteenth and nineteenth centuries, capital was raised by direct share offerings rather than by loan or security.

The reference books, in describing the company limited by guarantee, state that such a company "does not obtain its initial working funds from its members" and that such a company "is therefore only suitable if no initial funds are required or these funds are obtained from other sources - e.g. from endowments, fees, charges, donations or subscriptions" (*Palmer Company Law*, 21st edition, page 23). The author concluded from this that such a company "is obviously unsuitable as a form of organisation for ordinary business purposes." This is a statement which might have been true at the end of the nineteenth century when the first edition of *Palmer* was written (1898); but it is not a realistic statement when evaluated in the context of current economic conditions, when borrowing is so widely countenanced. The approach also did not contemplate that business could extend far beyond the categories of conventional trade, consisting of the purchase or manufacture and sale of goods: services-related business obviously does not need working capital in the same proportions except where regulatory bodies insist on standards of minimum permanent capital as one of the yardsticks for determining financial adequacy. Nor was it then contemplated that companies might become the basis for fulfilling social aims or objectives, as for instance where they might be used as private family holding enterprises. Rather, the author in 1898 extolled the principal virtue of the limited company without share capital as appropriate for "associations pursuing other purposes....e.g., professional associations, trade associations, research associations set up by companies operating in a particular field of business, associations for mutual information, for pooling and realising produce or other co-operative or mutual business". Such companies are also recommended where the objects are charitable or philanthropic in character.

Special Characteristics of the Guarantee Company Without Share Capital

Companies limited by guarantee have, with exceptions, exactly the same characteristics and possibilities for operation as ordinary limited (by share) companies. Thus their profits and assets can be distributed to their members. But there are the following matters which can be borne in mind:

1. Members of a company limited by guarantee and with no share capital do not have to be shown on Annual Returns relating to such companies. Bearing in mind that one of the objects of an Annual Return was to show not only the capital of the company but who provided it, this is logical because in a guarantee company without share capital no-one provides any share capital. (**NB** The privilege does not apply to companies limited by guarantee which are formed in Alderney, one of the Channel Islands.)

2. The company can purchase the interests of its members, without there being any illegality involved, such as an unauthorised reduction of share capital - for there is no share capital to reduce. The company can also

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charge its own assets to finance the acquisition of control over it insofar as control is not share-related.

3. Membership of such a company can in the case of non-shareholder membership be brought to an end by resignation or forfeiture; and in some cases can cease on death: see, for example, clause 4 of Table C to the Companies Act 1989 (Great Britain) and Companies (Memorandum and Articles of Association) Regulations 1988 (Isle of Man).

4. Although profits or assets are distributable, there is in most jurisdictions a prohibition on the distribution of divisible profits among non-members. This dates from section 27 of the Companies Act 1900 of England, which became (in later consolidating Companies Acts in England) section 21 in the Companies Acts of 1908, 1929 and 1948 before becoming section 15 of the Companies Act 1985. The modern context of the section, as compared with its origin, causes one to wonder whether the provisions in it have outlived their use. The commentary in *Buckley on the Companies Acts* (14th edition at page 68) states that the section was passed to counteract the formation of the sort of company which was the subject of the decision of North J in *Malleson v General Mining Patents Syndicate Limited* [1894]3 Ch 538. The case was concerned with a company which was limited by guarantee without shares or a share capital but which nevertheless made provisions for the undertaking of the company to be divided into equal shares, this being stated in the articles of association to be done "in order to determine the proportions in which the members for the time being of the company are interested in the company". The plaintiff contended that such provisions were ultra vires and illegal, on the ground that the effect of the provisions was to create a share capital to which the members were under no liability to contribute. It was held that expressing fractionally the interests of the members of the company in the manner specified by the articles did not amount to any attempt to establish a fixed capital or to divide that fixed capital into shares, when there was in reality no capital at all, and that the phrases "limited by shares" and "having a capital divided into shares" did not mean the same thing. Accordingly, the validity of the scheme of the company was upheld.

Following the decision it became convenient for companies to be formed with shares of no par value, or to have shares without creating a share capital, while preserving the limited liability concept (through the guarantee) without having to pay up on the shares or to pay up any share capital. This was looked upon unfavourably by the regulators of the 1890s, probably for two main reasons:

(1) By having shares with no need to pay for them, payment of company capital duty could be circumvented, which was considered to be contrary to the interests of the Board of Trade as registrar for companies; and

(2) Being able to formulate company capital without share capital meant that the capital could be reduced by distribution to non-members, thus circumventing the statutory restrictions on reducing company capital, which could only be effected where there was share capital and Court leave was obtained. If the need for share capital could be thus overcome, capital could be distributed, perhaps dissipated, without restriction, which might tend to encourage future insolvency as a result of inadequate member guarantees applicable in the subsequent liquidation.

Legislation, in the form of section 27 of the Companies Act 1900, was therefore introduced to meet both objectives, as follows:

- Subsection (1) of section 27 provided that any provision in the constitution of a company limited by guarantee without share capital, and whereby divisible profits could be distributed otherwise than to company members, was to be void. Note here that "divisible profits" was not defined. As the companies did not have share capital, this created an unrealistic distinction between assets which might be donated to the company to form part of its corporate undertaking, and which could be distributed to non-members - e.g., in furtherance of charitable or public objects - and profits from the exploitation of such assets - which could not be similarly so applied. Nor could such profits be thus applied even if Court sanction could have been available, as would be the position in an ordinary reduction of share capital. The sub-section also had the effect of preventing interest on capital raised from borrowings from being paid out of divisible profits (which may have accrued from a previous year), as might arise where current income was insufficient to pay the interest.

- Subsection (2) of section 27 effectively reversed the *Malleson* decision by providing that in relation to any company limited by guarantee, whether with or without a share capital, any provision in the constitution which provided for the company's undertaking to be divided into shares was to be treated as provision for a share capital. This provision also outlawed the creation of shares of no par value.

It should be noted that distributions of divisible profits can still be sanctioned in favour of non-members where the company limited by guarantee also has a share capital. This has important consequences, as we shall see later in this article. (**NB** Restrictions of the kind set forth in section 27 do not appear in the company law legislation of three colonial or ex-colonial jurisdictions - namely the Cayman Islands, the British Virgin Islands and the Bahamas Commonwealth.)

Taxation Aspects of Guarantee Companies

Companies limited by guarantee appear to have more expansive possibilities in jurisdictions in which capital is not subject to taxation. An attraction is that they import the conceptual possibility of distributing benefits which are not measured in proportion to subscribers' contributions (as is normally the case where the subscriber becomes a shareholder) and can even be wholly discretionary in nature, by linking them to non-shareholder membership, thus equating such membership with the position of a beneficiary under a discretionary settlement or trust and with which position it is closely analogous. The ability to equate company membership status with trust beneficiary status meant that if the latter was in the nature of discretionary then so could be the former, thus rendering the valuation of economic or equity interests in the company much less predictable, since they did not then have to equate with the value of the undertaking in which they subsisted, as did shares. This ability to be regarded as discretionary in valuation terms yet beneficial in equity rendered them unlike shareholders or stockholders and, indeed, if voting control could repose in the shareholders or stockholders - especially if participation in profit was discretionary - rendered the non-shareholder member potentially a non-participator in status. Companies having these characteristics were dubbed the "Mark I" version and were initiated in the mid-1970s as holding companies for condominiums or club developments in Spain and Portugal utilising the public company concept to give the enterprise some additional status.

But it was not long before it was realised that distributions to such members would still be income to the recipient whereas if from a trust to a beneficiary it could be treated as tax-free capital. This would not of course be as important where the company was being used as a pure holding vehicle rather than as a tax effective investment tool. The breakthrough in the latter respect came in 1977 and later, using the "Mark II" concept to which further reference will be made later in this paper.

Guarantee Companies with a Share Capital - The Original "Hybrid"

So far, the references to companies limited by guarantee have been to such companies as do not have a share capital. But such companies can have a share capital, even share capital where the shares are not, or not fully, paid for. Liability of members is not limited by the amount unpaid on the shares, but by the guarantee - as with other guarantee companies. When first conceived of, the members of such companies consisted wholly of persons holding shares; in consequence, the statutory model regulations for articles of association, originally described as Table D, were virtually identical with those of Table A which were expressly provided to relate to a company limited by shares. Even then, the adjective "hybrid" was attributed to such companies because they possessed so many features common to those relating to companies limited by shares. Indeed, apart from the form of limitation of liability, there was nothing to distinguish the two forms of company. This made them a prime candidate for extinction in the United Kingdom when the First Company Law Directive, originating in Brussels, was promulgated. That Directive had as one of its aims the harmonising of company incorporation categories, primarily in relation to public limited companies, throughout the various company legal systems of the various member States comprising the European Union. The systems of the United Kingdom, Northern Ireland and Southern Ireland had a number of features which rendered them at direct variance with their EU colleagues. This was inevitable, of course, given the different legal origins prevailing in the respective cultures. The company limited by guarantee with a share capital did not fit into the PLC framework, so a decision was made to exclude such companies from PLC status except where they were created earlier than a particular cut-off date, which date varied in each Member State. In the United Kingdom it was originally 2nd January 1980, though the date was later deferred to 22nd November 1980 following the enactment of the Companies Act 1980. In Southern Ireland it was 7th March 1982 following the enactment of the Companies Act 1982.

This lack of harmony made the company limited by guarantee with a share capital a target for extinction in the then reforming era of the time. Hardly any such companies have been formed for many years.

Extinction was given ultimate statutory effect in England by the Companies Act 1980 and applied to prevent such companies from being newly incorporated after 22nd November 1980.

Companies with Shareholder and Non-Shareholder Members

The decision to prohibit the creation of companies limited by guarantee and with a share capital in the United Kingdom after November 1980, was a pity. For one thing it left in place the by-now out of date statutory prohibition - referred to above - by which distributions of divisible profits otherwise than to company members were void where the company was both limited by guarantee and without a share capital. Such prohibition did not extend to prohibit distributions where the company was limited by guarantee and had a share capital. But of more potential interest, since 1879 it had become possible to create companies which were able to confer membership upon persons who might or might not hold shares. This state of affairs first became recognised as a result of the decision of Mr Justice Fry, as he then was, in *Re Albion Life Assurance Society* (in liquidation): *Winstone's Case* (1879) LR 12 ChD 239. That case, though it involved an unlimited company, was a decision concerning such a company having a share capital and having two classes of members - shareholders, and policyholders not being shareholders. On a summons in the course of the liquidation of the Society, it became necessary to decide whether a particular policyholder, a Miss Winstone, who had agreed to become a member of the Society and was registered as such a member in the Society's register of members - thus satisfying the conditions laid down by what was then section 23 of the Companies Act 1862 - as being necessary to be applicable for someone to be a member of a company - was a member even though not a shareholder, the constitution of the company being held to be drafted validly to contemplate both shareholder and non-shareholder membership. In the course of his judgment, at page 251, Fry J said:

> "It is said that the Act of 1862, although it defines a member in the manner I have pointed out, contains other sections which impose a third condition or predicate upon members of an unlimited company where there is a share capital viz., that the member has agreed to become such in the character of a shareholder. It is said that the Act contemplates a primary division of the companies into those which have and those which have not share capital, and that as the result of that it excludes the possibility of a company existing where there is both a share capital and members who are members, not as shareholders, but in some other character. Now, of course if I found that prohibition in the Act I should be bound to give effect to it. It is quite true, as has been pointed out, that there are many clauses which provide for the registration of shares, the return of shares, and so forth, where the shareholders are members of a company, but I am bound to say that, having attended to the very able arguments which have been addressed to me in this case, I do not find anything which is inconsistent with the existence of a company which has both a share capital and members who have constituted themselves such by agreement and who do not hold shares."

It was therefore the case that although the decision concerned an unlimited company with a share capital it was equally applicable to other companies having a share capital so as to enable their articles of association to create non-shareholder as well as shareholder members in such a company. That this is the case has been recognised in English company practice in regard to companies limited by guarantee with a share capital since 1979 and to companies limited by shares since 1995. Both are (or in the former case were) capable of being incorporated in England and have been so in recent years. In the case of a non-shareholder member of a company limited by shares, since such a member has nothing unpaid in respect of any share, he must have limited liability as equally as does any member who holds a fully paid share.

Non-United Kingdom Companies with Shareholder and Non-Shareholder Members

Companies formed in other jurisdictions with shareholder and non-shareholder members in the same constitution have been incorporated in Gibraltar since 1976; in the Isle of Man since 1977; in the British Virgin Islands since 1978 and in the Bahamas since 1982. They can also be formed in other ex-colonial jurisdictions - e.g., in the Cayman Islands, in Cyprus, and probably in jurisdictions east of the latter. They can also be formed in Alderney, one of the Channel Islands; and theoretically they can be formed in the Republic of Ireland, though the Irish Government is obstructing the creation of such companies (the situation is currently being tested in the Irish Courts).

Guarantee Companies and some Trust Comparatives

The earlier part of this ARTICLE included a brief summary of the similarity between the constitution of the modern United Kingdom-orientated incorporated company and its legitimate ancestor, the deed of settlement company. It now appears appropriate to draw some comparisons between trusts and companies. In the process one comes remarkably close to the idea of an incorporated trust - which does not exist in English law but which invites comparisons in the field of guarantee companies.

A. Certainty of Objects

It is a fundamental rule of English trust law that the objects of a trust must be certain. Put more specifically, purpose trusts are not permitted under English Chancery rules except where the purposes are charitable only in nature (though one or two jurisdictions have legal rules permitting the creation of such trusts). But the objects of companies enable purpose-related objects to be freely specified.

B. Perpetuity Rules

Under trust laws, the interests of eligible beneficiaries, if not absolute or in possession, have to become vested in interest within the perpetuity period - usually 80 years or within 21 years of the date of death of the last to die of the lives in being apparent from the terms and circumstances of creation of the trust. But in a company all interests, however tenuous, are vested, if only because the company itself is a vested entity. In consequence, the perpetuity rules have no application to benefits arising out of companies, which usually permit of perpetual succession until liquidation or dissolution

C. Beneficiaries

As is commonly recognised, all trusts must have beneficiaries, unless (in the absence of special jurisdictional rules) they are charitable, when they can be either charitable bodies or charitable purposes. In the case of companies, the beneficiaries from a company's activities are usually its members, but can, exceptionally, be persons who are not members of the company but who benefit at the instigation of either a directing member or some outside holder of a power, exercisable perhaps by a protector or other non-member. A company can also require that its assets or income be appropriated to purposes which may not necessarily be charitable. This ability can make a purpose company, which may be preferable to a purpose trust.

There is no statutory authority, and hardly any judicial learning, on the nature of the rights held by a member of a company limited by guarantee who is not a shareholder. The only significant authority is the decision of Megarry J in *Gaiman v National Association for Mental Health* [1971] Ch 317, a case concerned with the possible forfeiture of the membership rights of non-shareholder members of a company without share capital.

It is the case that a member of a guarantee company not having share capital does not have proprietary rights like a shareholder. His position is that he has mainly undertaken to contribute to the company in the event of it being wound up. He may have other rights, such as voting rights; and he may be entitled to participate in distributions of the company. The possession of or entitlement to acquire either right is sufficient to make him a participator in the company, so that in the event of the company being a close company, or a company which would be a close company if resident in the United Kingdom for tax purposes, income of the company in the former case, could prior to 1989, and chargeable gains (if they were only not chargeable by reason of the company's non-residence) could since 28th November 1995, be apportioned to such a person if he had been UK-resident for tax purposes.

It might be thought that the lack of proprietary rights which is a feature of the position of a non-shareholder member of a company limited by guarantee would operate to prevent such a member from being assessable to income tax or capital gains tax on distributions from a company or on sums deriving from the voting or participatory rights conferred by the articles of association of such a company on such a member. The protagonists of such thinking would no doubt stress the inalienability of the rights of such a member, as is the case in a company subject, as regards such a member and his membership, to Article 4 of Table C of the Companies Act 1989 (United Kingdom) and its Manx counterpart, the Companies (Memorandum and Articles of Association) Regulations 1988. Article 4 provides that membership of a company limited by guarantee without a share capital is not transferable and ceases on death, and provides for membership to be terminable by resignation. But researches into statute and judicial decisions indicate that such analyses may be superficial. It is certainly arguable that a distribution to a non-shareholder member out of the assets of a company not having a share capital would not be income within any Schedule or Case in the Income Tax Acts, and would therefore not be taxable in the hands of the recipient as income. The only Schedule and Cases which could be of relevance in an income tax context would be Cases III, IV, V, or VI of Schedule D. Case III would clearly not be relevant as the receipt would not be in the nature of interest, annuity or other annual payment; nor would it be within Case IV of Schedule D (as being income from a foreign security, as appears from the House of Lords decision in *Williams v Singer* (1921) 7 TC 419), nor within Case V of Schedule D (as being income from a foreign possession, membership not being a possession as that term is commonly understood). Nor is Case VI in point, since to be within the Case the income has to be in the nature of annual profits or gains. Although the House of Lords has held, in *CIR v Reid's Trustees* (1948) 30 TC 431, that a capital dividend in respect of a shareholding in an overseas-resident company was income in Case V, there is no basis upon which a non-shareholder can be equated with a shareholder in relation to a company.

However, where the company is resident for purposes of corporation tax in the United Kingdom, a distribution to a non-shareholder member will be equated with a distribution in respect of shares (Income and Corporation Taxes Act 1988 section 254(1)) and taxable under Schedule F accordingly. And a distribution from a company not so resident to a United Kingdom resident may, if the company is within the provisions of section 704D(1) of the same Act, be vulnerable to an income tax assessment as resulting from a tax advantage in respect of a transaction in securities which can be counteracted under sections 703 to 709 of the same Act, the non-shareholder members' rights being regarded as "securities" for the purposes of the sections (ibid., section 709(2)). If, therefore, it is desired that a United Kingdom resident receive a distribution out of the assets of a non-resident company which if the company was resident would be Schedule F income, the company may need to be rendered under the control of a company to which section 704D does not apply before a distribution to a United Kingdom resident is made. As a section 703 counteraction is assessable under Case VI of Schedule D, this could imperil a distribution to a non-domiciled United Kingdom resident, who could escape income tax if the distribution was in Case V if the remittance basis applied to the receipt.

As regards capital gains tax liabilities, the inalienable nature of the membership rights would not, it seems, preclude a capital gains tax assessment in respect of a non-income receipt in respect of non-shareholder membership. This appears to follow from the decision of the House of Lords in *O'Brien v Benson's Hosiery (Holdings) Limited* (1979) 53 TC 241. In that case a unanimous (though out of five Lords there was only one authoritative judgement and that (of Lord Russell) of very little substance) House declined to attach any importance to a contention that the non-transferable rights under a contract of service rendered them not an asset for the purposes of capital gains tax, so that a capital sum paid for the cancellation of such a contract was properly exigible to capital gains tax. As the top rates of income tax and capital gains tax are both 40%, this may render academic a question of whether a sum is income-taxable or capital gains-taxable.

D. Position Regarding Trust or Company Property

It is a fundamental characteristic of the trust that property or money is transferred or paid by a transferor or payer to a person or body of persons who (or which) hold it for the benefit of one or more third parties on any of a number of possible bases - absolutely, or for a period of life or lives or years and then for some other period or succession of periods. The trustees have no beneficial interest in the property or money with which they are endowed but have duties related to how the property or money is to be applied.

Except in the cases where a company is a trustee of money or property on declared terms, a company holds property for its own benefit and does not hold it on trust for its members or creditors except in a liquidation (*Ayerst v CK* [1975] 3 WLR 16). This is the case even as regards property which is given to a company (*Bowman v Secular Society* [1917] AC 406) except where express trusts are declared.

E. Discretionary Trusts and Companies

It is well settled law that trusts can be created which confer discretionary trusts and powers of benefit as regards capital or income in favour of one or more members of very wide classes of persons. A similar ability to benefit discretionary objects can be created for utilisation by a company, notably where the company is not one which is limited by shares.

Most companies require that distributions of their assets and income must be according to the proportions of the issued share capital which belong to the shareholders. In the case of companies limited by guarantee, the rights to participate in distributions of income or assets can vary, as being proportionate to the size of the guarantee given by each guarantor member, or it can be equal if the size of the guarantee of each member is equal. Or the articles can provide that as between non-shareholder members the directors can distribute income or assets to some members and not others, or even to non-members.

F. Transfer and Cessation of Beneficial Interests

It is well known that in trusts a beneficiary must be eligible to benefit from the trust to be able to enjoy income or capital from the trust fund, and that whether he or she has the right to benefit from income or capital to some extent depends on the terms of the trust and the particular interest made available to him. However, in the case of companies, beneficiaries normally consist of company members or loan creditors, although exceptionally the constitutions of companies can be adapted to enable persons who are not members of the company to benefit from payments of money or transfers of assets previously belonging to the company. It is the case that under current United Kingdom, and possibly under current United States, tax laws, such distributions may not be subject to current UK or US Federal taxes provided that, in the latter case, the stockholders are not themselves US citizens or US residents.

Once a person is eligible to receive a benefit, he or she will be entitled to benefit either as of right or on a discretionary basis depending, again, upon the terms of the trust. It is also possible for discretionary benefits to be available to members of the company as well as to non-members provided the constitution of the company is appropriately drafted.

The ability of someone to benefit from a trust will normally continue unless and until that ability is extinguished by a release or disclaimer of the interest. Where there is a company involved and the beneficiary is the holder of shares, the ability to benefit will derive from the shares. Where the ability to benefit derives otherwise than from the holding of shares, provisions of recent origin in what is now Table C to the Companies Act 1989 (in England and Wales) and 1988 Regulations (in the Isle of Man) make it possible for the ability to benefit to cease on death and not to be transferable meantime. These restrictions leave open the possibility of estate planning techniques where a person's estate may be reduced in value by the extinction of an ability to benefit from a company's assets.

G. Variation of Trust and Company Constitutions

In general terms, once a trust has been constituted then, in the absence of express provisions in the Trust Instrument, it is not possible to vary either the terms of the trust or the powers of the trustees. In modern times it has become relatively common practice for the trustees to be permitted to release or disclaim given powers that may be vested in them but as a rule these disclaimers are not often exercised.

In the case of a company, the Articles of Association can be freely altered by Special Resolution but the Memorandum of Association, which contains its objects (not usually present in post-1986 Isle of Man companies) and other provisions, is not normally capable of amendment unless the provisions in question relate to fluctuations in company capital. However, under both the UK and Isle of Man systems of law, it is possible for company constitutions to be re-cast and re-registered so that, for example, a company limited by shares can be re-registered as a company limited by guarantee with or without a share capital. This power remains in the Isle of Man, having been operable in that jurisdiction since 1879. In the UK, however, re-registration provisions have been greatly restricted since 1967 and it is now only possible for limited companies to re-register with unlimited liability and vice versa, and for public companies to be re-registered as private companies and vice versa.

The ability to re-register as a limited liability company having characteristics different from those in conventional limited liability companies - i.e., re-registered and limited by share company into a company limited by guarantee with or without a share capital - can have valuable consequences. These can be dealt with on an individual basis depending on the particular case or circumstance in which the point may be relevant.

H. Status of Distributions - Income or Capital

In practice, the status of a distribution from a trust will depend in the first instance on the nature of the trust and the status of the fund from which the distribution is made. In practice income which is distributed as it arises - either from time to time or in the same calendar year - will be treated as current income. Income which is not distributed as it arises and which is allowed to accumulate within the trust will become capital in the hands of the trustees, though certain UK tax-related legislation may deem accumulated capital to be income in the hands of the recipient.

In the case of a company, whether a distribution is income or capital depends upon whether it is related to a possession. This term "possession" in practice means an asset which may be in the nature of a security or shares or stock. It can also refer to other interests of members in companies (such as members where the company does not have a share capital) but it would appear that there is some doubt over the status of distributions which are thus related to this sort of membership - at any rate under systems of foreign tax law, e.g., USA.

I. Liabilities of Trustees of Trusts and Directors of Companies

This is potentially an enormous subject and, in the interests of maintaining the emphasis within this paper upon company matters rather than trust matters, this section is centred upon the liability of directors of discretionary companies.

It seems appropriate to consider the duties owed by the directors of a discretionary company to the company, its members and to non-members who may benefit from an exercise of a discretion by the directors in their favour.

It is anticipated that the set-up will be that the discretionary company will have transferred to it a controlling interest in the relevant private company. The private company will continue to be run by the same people as previously but the discretionary company will be set up and run by the directors. The persons in whose favour the discretions as to distribution may be exercised will be the same people as would have been the beneficiaries or objects of the settlement had one been executed instead of utilising a discretionary company.

The prime matter for concern will be the extent of the duties and responsibilities of those involved in running the discretionary company and also whether they will incur any responsibility by reason of the arrangement.

Those involved in the running of the discretionary company, principally the directors, will thereby incur duties and responsibilities in respect of the affairs and assets of the discretionary company but may also incur duties and responsibilities in respect of the affairs and assets of the private company controlled by the discretionary company.

The duties of a director of a normal company fall into two categories:

(i) fiduciary duties - for example, the duty not to make a secret profit; and

(ii) a duty to take care: for example, to take reasonable steps to ensure that dividends are not paid out of capital.

In the case of a discretionary company there may be additional duties imposed on the directors. This depends upon whether the creation of the discretionary company and the terms of its constitution are such as to create a trust or, alternatively, to impose on the directors duties analogous to those imposed on trustees of a trust. It is suggested that a company incorporated for exclusively charitable purposes is in the position of a trustee of its funds, or at least in an analogous position (see Buckley J in *Construction Industry Training Board v AG* [1973] Ch 173 at pages 186/187 and *Von Ernst and Cie SA v IRC* [1980] STC 111 at page 121). If such is the case then the company, and in turn the directors, will be subject to the same duties as trustees of a charitable trust.

In the context of a discretionary company the greatest risk of a trust being created would be if the constitution of the company created rights to which no member was entitled, or conferred powers on directors in respect of, say, the distribution of assets in respect of which no member had a right. In such circumstances it would be doubtful as to whether the normal contractual relationship between the company and its members would suffice to cope with the position created by the formation of the discretionary company.

Regardless of this trust point, the directors will owe fiduciary duties in respect of any discretions vested in them by the constitution of the discretionary company analogous to the duties of trustees of a discretionary trust or trustees in whom is vested a power, say, to enlarge a class of beneficiaries. The directors will be under a duty to consider the exercise of such a discretion from time to time when the discretion has become exercisable. Any exercise of the discretion would only be subject to the control of the Courts for the same reasons as an exercise of a similar power by a trustee.

Apart from the special duties discussed above imposed on a director of a discretionary company by reason of any discretions concerning the distribution of the company's assets, the directors will be subject to the usual fiduciary duties imposed on directors and the duty to exercise care and due diligence. It is assumed that the directors will always act in accordance with the powers conferred upon them so that there is no need to consider the position resulting from an ultra vires act.

Although directors have often been referred to as trustees in the authorities, a director is not a true trustee. A director will be treated as a trustee of any of the company's assets which come into that director's hands or control, but only to the extent that a misapplication of those assets will give rise to a breach of trust. The duties of investment imposed on a trustee (for example, not to be involved in speculative and hazardous transactions) will not similarly be imposed on a director. For example, in *Re Lands Allotment Company* [1894] 1 Ch 616 at page 639 Kay LJ stated that:

> "directors are not always trustees. As directors they are not trustees at all. They are only trustees qua the particular property which is put into their hands or under their control, and which they applied in a manner which is beyond the powers of the company."

The limitation on the extent to which directors can be treated as trustees means that (on the assumption that there are no ultra vires applications of the company's assets) the principal concern for the directors of a discretionary company will be the duty to take care, rather than the fiduciary duties or duties analogous to those of a trustee. It is not anticipated that a discussion of the different types of fiduciary duty imposed on a director is required in this paper.

In a case where the assets of a discretionary company include a controlling interest in a private company which has gone down in value, the likeliest ground for complaint is that the directors of that discretionary company have not exercised due care and diligence.

One of the remarkable features of this area of law is the fact that there has been little recent discussion or development of the standard of care that must be exercised by the directors of a company. The main authority on this point is still *Re City Equitable Fire Insurance Co* [1925] 1 Ch 408.

Apart from the duty to act honestly, a director must satisfy the general duty to exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man ought to be expected to take, in the circumstances, on his own behalf (per Romer J). This general duty was expressed to be subject to three propositions (pages 428/429) which will not assist the directors of a discretionary company. These were:

(i) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.

(ii) A director is not bound to give continuous attention to the affairs of the company. However, someone must have responsibility for managing the affairs of the discretionary company.

(iii) A director may delegate certain duties to other persons without thereby incurring responsibility in the absence of grounds for suspicion.

It was made clear in *Re City Equitable Fire Insurance* (supra) that the particular standard of care expected from a director depends very much on the particular circumstances, including the business of the company, its size and the manner in which it is operated. It is clear that the standard of care is not as great as that imposed on a trustee. It must be borne in mind that it will be reasonable to expect that the persons involved with the discretionary company will either know or ought to have known all material information concerning the discretionary company and its affairs. This means that without any provisions in the Articles of Association to the contrary there is a duty on the directors of the discretionary company to obtain information concerning the affairs of the private company in which the discretionary company has a controlling interest.

In *Re City Equitable Fire Insurance* (supra) Romer J took the view that it was the duty of each director to see that the company's money was in a proper state of investment from time to time insofar as such duty could be delegated under the constitution of the company to others. In particular, he considered that before presenting the annual report and balance sheet to the shareholders and before recommending a dividend, each director should have a complete and detailed list of the company's assets and investments and must satisfy himself as to the value of each.

In the event that a director is not himself competent to determine the value of any asset or investment, then independent advice should be sought rather than leaving the matter to others (see Buckley J in *Re Duomatic* [1969] 2 Ch 365 at 377 concerning the need for a director to obtain independent legal advice).

Leaving aside for the moment the possibility of there being provisions in the company's constitution restricting the duties of the directors or exempting them from liability, it is considered that the directors of the discretionary company will be under a duty to obtain information about the affairs of the private company controlled by the discretionary company so as to ensure that the private company is being managed properly by its own directors - for example, that the value of that company's assets are not at risk or an opportunity to make a profit is not being lost.

There will be a further duty on the directors of the discretionary company to consider what action, if any, should be taken if the available information indicates that there is something wrong with the affairs of the private company. A failure to act may be sufficient to give rise to a liability (see *Joint Stock Discount Co v Brown* (1869) 4 LR & Eq 381).

An error of judgment will not by itself be sufficient to found liability. Further, involvement be the private company in a speculative and hazardous transaction will not by itself by sufficient to give rise to a claim in the event that a loss is incurred as a result of the transaction. There is a very sharp difference between the responsibilities of trustees having a controlling interest in a private company vested in them and those of directors of a company having such an asset. The principal dangers for such directors will not be involvement in hazardous transactions but failure to obtain necessary information and failure to act once it is known that things are going wrong.

The responsibilities of the directors of the discretionary company will be increased if the board of directors of the private company is not wholly separate and the management of that company is not carried on by that board, rather than by the directors of the discretionary company. Without a separate board making its own decisions there is a danger that the directors of the discretionary company will become de facto directors of the private company controlled by the discretionary company (see in this respect *Unit Construction Co Ltd v Bullock* [1960] AC 351 where residence of subsidiary determined by place of management of head company). There has been little judicial discussion of the responsibilities of the directors of the head company for the subsidiary or the extent to which its interests can be taken into account.

In *Chesterbridge Corpn Ltd v Lloyds Bank* [1970] 1 Ch.62 Pennycuick J (page 74) took the view that though a director of a company could not look purely to the interests of the group of which the company is a member as opposed to the interests of that company, it is open to a director to take the view that the company may benefit from a transaction which is in the interests of the group. He did state, however, that each

> "company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company."

Although the duties of a director are less onerous than those of trustees, it is more difficult to relieve the directors from those duties. Although provisions may be included in the constitution of the discretionary company relieving the directors from any duty to obtain information concerning the affairs of the private company controlled by the discretionary company, the Courts would be very reluctant to give effect to them as they would run contrary to the basic function and position of directors within the company. It may be that certain functions could be taken away from the directors and left to the members in general meeting. This depends on how the rights in the company are defined in the company's constitution. Even then, it must be one of the basic duties of the directors to supply the members with advice and information.

With an English company it is not possible to include in the constitution a provision exempting the directors from liability for any breach (section 310 Companies Act 1985). Company law in operation in the Isle of Man, Gibraltar and Cyprus is similar to the 1929 Companies Act. Therefore no exemption clause will be valid (section 152 Companies Act 1929). Similar clauses exist in section 151 Companies Consolidation Act 1931 (Isle of Man) and section 145 Companies Ordinance 1955 (Gibraltar). Before 1929 it was possible to exclude liability save for dishonesty and wilful default. It would be possible to include an exemption clause in the constitution of the discretionary company if the law of the territory of incorporation is the Cayman Islands or the British Virgin Islands. None of these laws include any provision similar to section 310 of the 1985 Act. As with trustees, it is not considered that it could exclude liability resulting from dishonesty or wilful default (for a discussion of the meaning of "wilful default" see *Re City Equitable Fire Insurance* supra).

There is the point as to whether approval of the annual accounts in general meeting could in certain circumstances be treated as ratification of certain of the directors' acts by the members. In *Blackburn and District Benefit Building Society v Cunliffe Brooks & Co* (1885) 29 ChD 902 Colton LJ (at page 910) stated that:

> "mere omission to question the accounts or acts of the directors cannot properly be treated as ratification."

Approval of the annual accounts was held in that case not to be capable of constituting ratification.

In order to reduce the risk of liability being incurred by the directors of the discretionary company, one possibility might be for more than one discretionary company to be used so that no one discretionary company will have a controlling interest in the private company. Such a step would make it much more difficult for a discretionary company to obtain information or to take any action in respect of the private company. However, as in such circumstances the sensible course of action would be for the discretionary companies to act jointly to protect their holdings, this may not significantly reduce the risk of liability.

J. Trading by Trusts and by Companies

In general terms trustees do not have power to trade unless the power is expressly conferred upon them by the terms of the trust deed. Companies, however, can usually trade, especially in the case of Manx companies where objects are now stated to consist of anything which an individual can do.

K. The Role of the Protector

This part of this paper is concerned with the extent to which a company can be administered so that its non-members are the persons primarily able to benefit from its activities without in the process creating a trust for the benefit of such individuals or any of them.

In practice, the only way in which a company can be restrained from making benefits available to its non-members and from declining to make benefits available to persons who are members, is where there is a clause in the constitution of the company which vests a restraining power of this nature in some third party, preferably not someone who is a member of the company and certainly not someone who can himself benefit from being the restrainer of actions.

Readers of this paper are familiar with the concept of a trust protector, an office which is beginning to grow in both legal standing and popularity. But it should be realised that a protector can just as easily act as protector to a company as he can in a trust.

Taxation Aspects of Guarantee (and other) Companies

The subject of taxation in relation to all companies is not a subject which can be condensed into a few short paragraphs. Until the end of the 1950s the liabilities of companies and their associates to taxation were largely confined to direct tax, assessable upon and payable by the particular company, in respect of its income or profits, with no liability on gains of a capital or non-trading nature, these tax liabilities arising under the tax laws of the countries in which the particular company was initially established and with little, if any, attributory liability applicable to third parties who did or might benefit from the particular company's activities. The most well known illustration of attributory liability was that created by the United Kingdom's legislation, dating from section 18 of the Finance Act 1936 which became section 412 of the Income Tax Act 1952, and with some improvements to trap the clever tax avoiders of the time in section 33 of the Finance Act 1969; this then became section 478 Income and Corporation Taxes Act 1970, now, with a range of supplementary tax teeth, represented by sections 739 and 740 Income and Corporation Taxes Act 1988. The provisions of section 478 - without the supplementary teeth - were enacted into Irish tax law by sections 57 to 60 Finance Act 1974 and are of application equally to the Irish ordinarily resident tax avoider seeking to benefit from securing the offshore companies as their United Kingdom counterparts are affected by what is now section 739. But in the forty-seven or so years since the end of the 1950s the whole tread of tax avoidance, anti-avoidance and countering the anti-avoidance has changed. The United Kingdom now has a range of attributory anti-tax avoidance legislation which is almost second to none, and which is designed to prevent the avoidance of United Kingdom tax in relation to the use of offshore companies and trusts, and other persons, either by persons residing in the United Kingdom or by persons who though not residing in the United Kingdom nevertheless avoid United Kingdom tax liabilities, either in relation to prospectively United Kingdom-taxable enterprises where liability can be avoided by relevant offshore enterprises, or in relation to direct or portfolio investment into the United Kingdom when liabilities to United Kingdom taxation are frequently claimed against overseas individuals who are vulnerable to claims through not having taken proper advice at an appropriate early stage.

The comments below are general, are not intended to be exhaustive and are made by particular reference to offshore companies in general, whether guarantee companies or not. All difficulties are capable of being overcome if proper advice is taken and not implemented too late. The principal categories of available counter-liability are shown below where appropriate. Direct tax liabilities are not considered as these will depend on appropriate local laws.

Attribution to UK Residents of Income and Capital Gains of Offshore Companies

A. Income

By virtue of provisions now contained in sections 739 and 740 Income and Corporation Taxes Act 1988, all income of the company, whether distributed or not, can be treated for income tax purposes as the income of anyone ordinarily resident in the United Kingdom if either they or their spouse can enjoy any of it in whatever form or if the individual in question or spouse receives or is entitled to receive a capital sum connected to the creation of the income source. The particular UK resident does not have to own any shares in, be a member of or have any beneficial connection with, the company in question. All there has to be is income which becomes payable to the company, the "income" being anything chargeable to UK income tax under any of the Cases or Schedules of the UK Income Tax Acts. Only income which is so payable as a result of a situation created without regard to tax avoidance considerations is outside the ambit of the sections.

The scope of sections 739 and 740 are now so wide that if the intention is to run the company in question for the benefit of individuals ordinarily resident in the United Kingdom the company will have to rely on capital rather than income accumulation. If it is desired that there be income accumulation, the only species of income outside the ambit of section 739 or 740 is:

(a) income which becomes payable otherwise than through tax avoidance purpose;

(b) income which becomes payable to a person incorporated and resident inside the United Kingdom but from which a capital receipt can accrue to the overseas company;

(c) income of the company to which section 739 or 740 cannot apply because it is deemed by the Tax Acts to be the income of a non-resident so as not to belong to the initial payee; or

(d) income which is deemed to be income for UK. tax purposes and is not therefore "income which becomes payable" to anyone; or

(e) trading profits (but see Hoffman J in *Brackett v CIR*).

Expatriates who become UK-resident can also be rendered subject to UK income tax on becoming resident. This position is at present not free from doubt, which the House of Lords will be asked to clarify in *Willoughby v CIR*.

B. Capital Gains

Until 28th November 1995 the law enabling the attribution of capital gains in offshore companies to UK residents had remained largely unchanged since first enacted as section 41 of the Finance Act 1965 (later section 15 Capital Gains Tax Act 1979 and section 13 Taxation of Chargeable Gains Act 1992). Even now, gains can only be imputed beyond the company if the company being non-resident for UK tax purposes would be a close company - i.e., (under the control of five or fewer participators) if it was adjudged resident. But whereas prior to 28th November 1995 only participators holding shares and entitled to the fruits of the company on a winding-up were the subject of attribution, gains are now liable to be apportioned among ALL the participators whether resident or not, only those domiciled and resident in the UK being assessable in respect of such proportion of the gain as can be attributed to them on a just and reasonable basis.

The legislation defines a participator as "a person having a share in the capital or income of the company" (section 417(1)) and then continues by stating that the term includes:

"(a) any person who possesses or is entitled to acquire the greater part of the share capital, issued share capital or voting powers in the company;

(b) any person who is a loan creditor otherwise than in the course of a business of banking;

(c) any person who is entitled to participate in distributions of the company; and

(d) any person who is able to secure that income or assets of the company has been or will be applied to him or for his benefit."

There is no modern guidance on the use of these words, save that in relation to a legislative predecessor of subsection (1)(d) of section 417, the House of Lords has held that the words "able to secure" do not import any element of permanence and can include securing by illegal means - e.g., breach of trust - see *CIR v LB (Holdings) Limited (in liquidation)* (1946) 28 TC 1.

Viewed in non-technical terms, the expression "participator" normally extends to persons who are in any of the following categories:

- anyone possessing or entitled to the authorised or issued share capital or voting rights in a company
- any loan creditor other than a banker
- anyone entitled to participate in distributions in respect of shares, stock, member's rights, securities or debentures; and
- anyone able to secure that income or assets of a company will be paid or applied to them or for their benefit.

BUT NOT

- ex-members or ex-creditors
- persons who have never been members or creditors

The legislation provides that liability to capital gains tax on chargeable gains accruing to the particular offshore company is arrived at by apportioning the gain among all the participators according to the extent of their respective interests in the year in which each gain is made, and then raising assessments to capital gains tax on the proportions of the particular gain which are referable to interests which belong to individuals who are domiciled and resident in a part of the United Kingdom for tax purposes during that year. Persons holding interests amounting to 5% or less of the total value of the participators' interests are to be disregarded.

The foregoing is a brief summary of the literal statutory provisions presently in the Finance Act 1996. The relevant section is section 174.[2] Some conclusions can already be drawnfrom the provisions if they are reviewed against the legislative background to their introduction:

(A) The legislation at present does not appear to have related to it any policing or enforcement mechanism, in contrast to the position concerning trusts which have non-residents as trustees but one or more settlors who are UK residents when the particular trust or settlement is made. Legislation requires that such settlements be notified to the Inland Revenue within a year of their creation. The settlement is then given a file reference and annual return forms are issued to non-resident trustees, usually via UK-located professional bodies or agents whose co-operation in completing them can be relied on. Interestingly, Claims Branch at Bootle are now demanding that trustees of resident trusts supply full particulars of any investment in any company incorporated outside the United Kingdom, if not a quoted company. A similar question may in due course be included in Tax Returns issued after 28th November 1995.

(B) The present capital gains tax regime does not impose tax or corporation tax on gains or income of non-resident companies unless any carry on a trade or business through a branch or agency in a part of the United Kingdom or are registered as overseas companies under the English Companies Acts as having a permanent place of business in a part of Great Britain. Even then, an offshore company failing to register in Great Britain as an overseas company is not disabled as is a foreign company failing to register in the Isle of Man - as by being unable to own Manx real estate. So again, no policing routine is available for companies who should register but fail to.

(C) The draft legislation is at present silent on when apportionments have to be made or how they are made. Further legislation will be needed to provide clarity on the issues. But the apportionment concept reflects earlier provisions in the old surtax rules valid between 1918 and 1965 and the pre-Finance Act 1981 apportionment rule as applied to where a settlor resided in the United Kingdom and the trustees resided outside the United Kingdom (contained in section 42(2) Finance Act 1965 later re-enacted at section 17(2) Capital Gains Tax Act 1979 as finally interpreted and applied by the House of Lords in *Leedale v Lewis* [1982] STC 835; 56 TC 501). Reference can be made as regards the former to the current (Third) edition of *Simons Taxes* - Volume D at Chapter D3.301 to D3.329 (pages 621/671). As regards the latter - i.e., the *Leedale v Lewis* approach - there are two

[2] When the paper from which this article derives was given on 17th April 1996 the Act was then still a Bill before Parliament. The section was then Clause 164. The Bill received Royal Ascent 29th April 1996.

strong pointers in the new draft clause that the Revenue intend to invoke aspects of the *Leedale-Lewis* rationale in applying the apportionment concept. One is to be found in the amendment of subsection (3) of section 13 of the Taxation of Chargeable Gains Act 1992, introduced in subclause (5) of section 174 and in which it is provided that henceforth the part of the gain to be apportioned

> "shall be equal to the proportion of the gain that corresponds to the *extent* of the participator's interest as a participator in the company;"

The use of the word "extent" in preference to the word "value" indicates that the proportion is to be measured by facts and circumstances rather than by reference to mathematical or actuarial valuation considerations. A second pointer is that after importing the participator definition from section 417(1) Income and Corporation Taxes Act 1988 a new (d) of the new proposed subsection (12) provides that:

> "references to a person's interest as a participator in a company are references to the interest in the company which is represented by all the factors by reference to all of which he falls to be treated as a participator"

In the context of "factors", an amendment was made to section 174 during the Committee stage of the Finance Bill (when it was still Clause 164). This amendment appears to be an attempt to extend the definition of "participator" in the context of a settlement so as to equate the interest of a beneficiary in the settlement with the interest of the trustees of the settlement in the company. This is attempted by means of an amendment to sub-clause (a) of section 174 so as to add a new subsection (13A) after the proposed new subsection (12)(b) to be part of the amended section 13 of the Taxation of Chargeable Gains Act 1992 which reads as follows:

"(13A) For the purposes of this section, where:

(a) the interest of any person in a company is wholly or partly represented by an interest which he has under any settlement ("his beneficial interest"), and

(b) his beneficial interest is the factor, or one of the factors, by reference to which that person would be treated (apart from this subsection) as having an interest as a participator in that company, the interest as a participator in that company which would be that person's shall be deemed, to the extent that it is represented by his beneficial interest, to be an interest of the trustees of the settlement (and not of that person), and references in this section, in relation to a company, to a participator shall be construed accordingly."

The apparent object of the new subsection is to equate the interest of a beneficiary in a settlement with the position of the trustees of the same settlement in determining whether the trustees have participator status in relation to the participator company. The operative word is "apparent", for it is the case that a beneficiary under a settlement is not normally to be regarded as a participator in a company unless he is within the scope of paragraph (d) of subsection (1) of section 417. The new subsection seems to be an attempt to extend the scope of the term "participator" in the strictly restricted context of section 13 by attributing to a beneficiary as a "factor" whatever could be attributed to a body of trustees in an evaluation of its own participator status.

However, although this subsection has to be read with section 86 of the Taxation of Chargeable Gains Act 1992, which by reason of provisions contained in Schedule 5 paragraph 1(3) of that Act and an amendment to section 13 in subsection (10) of the new clause, enables a section 13 apportionment to be extended via the trustees of a settlement to a settlor having an interest in the settlement, the amendments do not go so far as to import into section 13 the definitions of "settlement" and "settlor" which are applicable to non-resident trusts and which are contained in sections 87 to 98, Taxation of Chargeable Gains Act 1992 - i.e., the income tax definitions applicable to those words and contained in section 660, Income and Corporation Taxes Act 1988. Since there is no general definition of the term "settlement" in the capital gains tax legislation, the term must bear its context meaning, which is one in relation to the term "settled property" which is defined in section 68 of the 1992 Act as property held in trust other than by a nominee or bare trustee.

It is also to be noted that if a body of trustees cannot be brought within the meaning of the term "participator" in section 417(1) of the 1988 Act there is no liability to render a beneficiary within the term. Thus if a trustee is a non-shareholder member of the relevant company, does not have the greater part of the voting power and is not entitled to participate in distributions, nor to secure the application of income or assets for his benefit and is not a loan creditor, mere membership of the company does not make the trustee a participator. In consequence, a beneficiary who can benefit through a securing of application of income or assets is not a participator and his ability to benefit may then not be a relevant factor for the purposes of determining the factors referred to in the amended subsection (13) and (13A) of section 13, though the point is not free from difficulty.

Surprisingly there were no other supplements to the clause. One might have expected a supplementary Schedule to deal with apportionment criteria but none has been proposed.

Still in the context of factors, attention should be focused upon the decisions of the Court of Appeal and House of Lords in *Leedale v Lewis* [1982] STC 835; 56 TC 501 that although the words of the charging section (section 42(2) of the Finance

Act 1965) and referred to earlier in this paper, required that apportionment "be in such manner as is just and reasonable between persons having interests in the settled property........ and so that the chargeable gain is apportioned as near as may be according to the value of those interests..........", nevertheless the requirement that the apportionment be made in a just and reasonable manner enabled account to be taken of the circumstances of the case. In the particular matter, a letter of wishes was taken as strongly indicative of what might be just and reasonable. In addition, the word "interest" was held to be sufficient to include a discretionary object when such an object's extent of interest was able to be evaluated according to a letter of wishes. In the particular case, the Court of Appeal also expressed the view (see 56 TC at pages 518 and 519) that in an example where property was directed to be held on discretionary trusts for fifty years, with an overriding trust for accumulation of income so long as no discretionary object is living with an overriding gift over for X (who was alive and not a discretionary object), then a gain made by the settlement trustees should be apportioned in its entirety to X if at that time he was domiciled and residency or ordinarily resident in the United Kingdom. It was also observed that section 42 applied equally to "arrangements" as to trusts.

The "just and reasonable" criterion is written by the subsection (9) of section 174 into the amendments to section 13. The subsection imports the just and reasonable basis of apportionment by means of a new subsection (12)(b) to section 13.

To the extent that the belief, that the Revenue intends to import ratio decidendi of the *Leedale v Lewis* decision into the capital gains tax apportionment regime proposed to affect section 13-affected non-resident companies, is well founded, then in the absence of varying legislation it is an equally valid conclusion that one has to import, as well, the "warts" which are associated with the rationale. The legislation is, as already pointed out, silent on the question of how apportionments are to be made as between participators, save that it provides (in section 174(13)(b)) that such apportionment is to be among *all* participators, so that the apportionment process is not restricted in its application to UK-domiciled and -resident participators (though under section 13 as originally enacted only individuals so classified can be charged to capital gains tax (see section 13(2)) *And* that apportionments are to be on a "just and reasonable" basis (as provided in clause 164(13)(b), referred to above).

The "warts" already known about are identifiable in three specific areas:

1. The time at which an apportionment is to be made, and the position where an interest in the company in question is held by successive participators - as where a shareholder transfers his shares after the company which issued them has made a gain which would be a chargeable gain if the company had been resident in the United Kingdom for tax purposes. The legislation being silent on both issues, existing jurisprudence dictates that the apportionment process should be applied on the last day of the fiscal year in which any such gain or