Capital Gains Tax

Mixed Funds in Offshore Structures

MACFARLANES

Jennifer Smithson

Iskra Doukova

Jack Engelberg[*]

Capital gains tax; Distributions; Liechtenstein; Mixed funds; Offshore funds; Separability; Tax administration

This article relates to a question about offshore funds with which advisers have had to wrestle for several years with varying degrees of success. Readers of this journal will be familiar with a number of provisions dealing with income tax and capital gains tax in this general field. Taking pride of place, no doubt, is the anti-avoidance provision relating to the transfer of assets abroad, now enacted as ss.714 to 751 of the Income Tax Act 2007. And for capital gains tax there are provisions in ss.3 to 3G and ss.86 to 97 of the Taxation of Chargeable Gains Act 1992 dealing with assets held by overseas-resident companies and trustees. A perennial problem has been to determine whether a mixed fund of assets held in such a structure represents capital or income, especially in a case where record-keeping has been sub-optimal, and whether distributions from such a structure to a beneficiary resident in the UK are subject to income tax or capital gains tax. Now a proposal from Liechtenstein professionals to un-mix such funds on a standard basis has been accepted as reasonable by HMRC, and this article describes its effect. Further, the article explains that, in theory, this should not be limited to Liechtenstein.

Introduction

In an email to its members dated 13 May 2019 the Liechtenstein Institute of Professional Trustees and Fiduciaries ("LIT") reported that HMRC has approved as "reasonable"[1] (albeit not formally binding) its proposals in relation to the treatment of mixed funds held by Liechtenstein foundations and trust structures.[2]

The proposals allow Liechtenstein trustees to calculate the income, gains and capital proportions of mixed funds in accordance with centrally maintained investment performance tables. This would not, of itself, be particularly newsworthy, because it is consistent with published HMRC practice that:

[*] Jennifer Smithson (jennifer.smithson@macfarlanes.com, 020 7831 9222) is a partner in the private client department at Macfarlanes LLP. She advises on all areas of personal tax and succession planning with an emphasis on cross-border tax advice, particularly with a US or French aspect. Iskra Doukova is a solicitor and Jack Engelberg is a trainee at the firm. Contact details: Macfarlanes LLP, 20 Cursitor Street London EC4A 1LT.

[1] The LIT email refers to a letter dated 20 December 2018 from HMRC, whereby HMRC confirmed that it considered the outlined approach to be reasonable, however the authors have not had sight of this letter.

[2] According to a 6 December 2018 letter from the LIT to John Shuker, Deputy Director of HMRC. The proposals as drafted refer only to "trusts" but it is assumed that they are expected to apply to foundations and other fiduciary structures (but not to companies).

> "Reference may be made to using investment performance information for each relevant year that may have been compiled by professional trust associations specifically for this purpose. This may provide an acceptable alternative to using an estimated calculation in situations where the original records are not held, or cannot be obtained."[3]

What is of note, however, is that HMRC also appears to have agreed that trustees can go one step further and separate out the constituent income, gains and capital parts into segregated and identifiable pots, and that for any trusts settled prior to 1999 "a pragmatic approach will be adopted by treating the funds managed at 1999 as 100% capital."

Although distributions from Liechtenstein structures will continue to be subject to UK tax in accordance with general principles as and when matched against the agreed pools of trust income and gains, this unmixing opportunity may be very helpful for Liechtenstein structures with UK beneficiaries.

More generally there is no obvious reason why this opportunity should be limited to Liechtenstein structures, and we would expect HMRC to be encouraged to extend the same approach to all non-UK structures. Failing to do so would be to give Liechtenstein fiduciary service providers a clear commercial advantage, since the proposals state that they will apply "for historic trusts and new trusts which migrate to Liechtenstein's financial centre." Extending this opportunity beyond Liechtenstein structures (especially given that it is not a one-off time-limited window) could materially impact the management of older trust structures which have not historically been run in a "UK facing" manner and the way in which funds held in those structures could be used to benefit UK beneficiaries.

Background—mixed fund rules

Where an individual is a UK resident non-UK domiciliary ("RND") who benefits from the remittance basis of taxation, special rules apply to determine the characterisation of transfers out of so-called "mixed fund" accounts (that is, accounts which contain a mixture of income, capital gains and capital and/or funds from different tax years) in order to determine whether or not tax is due in respect of remittances to the UK.[4]

Different rules apply depending on whether the transfer is an "offshore" transfer (i.e. a transfer from a non-UK account to a non-UK account) or an "onshore" transfer (i.e. a transfer from a non-UK account to a UK account).

A statutory order is applied to "onshore" transfers. Broadly, income is deemed to come out first, followed by capital gains, followed by capital. These rules operate on[5]:

- A "worst-first" basis (meaning, in broad terms, that categories of income and capital which are taxable in the UK at higher rates are generally treated as remitted in priority); and
- A year-by-year basis (meaning that income arising in the current tax year is treated as brought to the UK in priority to income or gains from prior tax years).

> **"Example**
>
> Suppose that an onshore transfer of £50 is made from a non-UK account which contains £25 of income from the 2017/18 tax year, £40 of income from the 2016/17 tax year and £35 of original capital. The £50 will be deemed to comprise £25 of income from the 2017/18 tax year and £25 of income from the 2016/17 tax year."

[3] *International Manual* 600030.
[4] Income Tax Act 2007 s.809Q.
[5] Income Tax Act 2007 s.809Q(3).

By comparison the "offshore" transfer rules (i.e. a transfer from a non-UK account to a non-UK account) operate differently: a transfer from one non-UK account to another is treated as comprising a proportionate amount of the capital, income and capital gains in the transferor account.[6]

These rules are complicated and can lead to illogical results in practice. In particular the "offshore" transfer rules make it very difficult in practice to "unmix" a mixed fund into its constituent parts, even if you have been keeping track of how much capital, income and capital gains the account contains. At the same time the "onshore" transfer rules ensure that transfers from a mixed fund into the UK will usually be taxed at the highest applicable rate.

The mixed funds rules apply with effect from 6 April 2008. They apply to any fund which contains a mixture of a remittance basis user's different kinds of income and capital. These rules would also therefore apply to mixed funds held by trustees or other third parties to the extent the various sources of income and gains within the mixed fund belonged to, or were deemed to belong to, a remittance basis user.

For this reason it had historically been good practice not only for RND individual taxpayers to segregate—so far as it was possible to do so—different sources of income and capital, but also for trusts settled by such individuals to do so to the extent of (i) assets added to the trust which derived from the settlor's foreign source profits and (ii) income arising within the structure itself, since this was deemed to be the settlor's income for UK tax purposes.

With effect from 6 April 2017 the circumstances in which this segregation is necessary may be fewer since, with effect from that date, income arising within most trust structures settled by RNDs will not be deemed to be the settlor's income for UK tax purposes, and the same treatment will apply (with some exceptions) to pre-6 April 2017 income.[7]

Notwithstanding this, the majority of non-UK trustees (particularly where structures were not set up with UK tax advice) do not maintain account segregation, and those trustees who can come within the scope of the Liechtenstein proposals almost certainly would not have done so, since it seems implicit in the proposal that it applies only to trusts whose trustees are not otherwise able accurately to calculate the income and capital gains of the trust. Additionally, it is not possible—absent specific legislation or HMRC agreement to that effect—to segregate capital gains from underlying capital.

One-off relief for mixed funds held by individuals

In the run up to the reform, on 6 April 2017, of the tax regime applicable to RNDs (and in order to encourage inward investment into the UK), HMRC introduced a one-off opportunity for RNDs to separate income, capital gains and capital which had become mixed in a single account.

The relief allowed all RNDs, even if they did not become deemed domiciled from 6 April 2017 (but excluding so-called "formerly domiciled residents" born in the UK with a UK domicile of origin), to separate a mixed fund into its constituent parts and thereby extract from existing mixed funds clean capital which could be brought to the UK free of UK tax and/or capital gains which would be taxed at the lower capital gains tax rate.[8]

However, the relief was subject to a number of restrictions:

(1) Although the taxpayer did not have to identify all the constituent parts of the mixed fund, they did need accurately to identify and calculate the amount of capital, income or capital gains which they intended to transfer out of the mixed fund.

(2) The relief was a one-off and was only available between 6 April 2017 and 5 April 2019.

[6] Income Tax Act 2007 s.809R(4).

[7] Income Tax (Trading and Other Income) Act 2005 s.628A and Income Tax Act 2007 ss.721A and 729A.

[8] For formerly domiciled residents see M. Herbert, New Rules on Deemed Domicile and Foreign-Owned Residential Property [2018] P.C.B. 49.

(3) This opportunity was available only for mixed funds held by individuals personally or via partnerships. Mixed funds held by companies or trust structures connected with RND taxpayers were excluded from the relief, although there was no obvious reason for this at the time.

The LIT proposal

In this context, and in particular given the final restriction above, the LIT put forward a proposal to HMRC on 6 December 2018 in relation to the treatment of mixed funds managed by Liechtenstein trustees with UK settlors or beneficiaries. In broad terms, the proposal sets out:

- A pragmatic approach to calculating the constituent parts of the mixed fund where segregation has not previously taken place, the segregation was incorrect or incomplete or records are missing or inadequate; and
- A procedure whereby, once the figures have been calculated, the trustees can separate out the mixed fund into its constituent parts.

Calculating the constituent parts

In relation to calculating the constituent parts, the proposal is based on a Standard Performance Table ("SPT") developed in conjunction with a Liechtenstein asset management company and based on real market data. The SPT will actually be a series of tables in four different currencies (GBP, CHF, USD and EUR) with annual performance indicators from 1999 onwards[9] based on four investment strategies:

(1) Defensive—funds with 10 per cent equity holdings;
(2) Conservative—funds with 25 per cent equity holdings;
(3) Balanced—funds with 50 per cent equity holdings; and
(4) Aggressive—funds with 75 per cent equity holdings.

Trustees will need to identify:

- What proportion of the funds is capital. In this context the proposal suggests that the funds contributed to the trust when it was settled will be 100 per cent capital. As market data prior to 1999 is not available, funds held as at 1999 will also be treated as 100 per cent capital; and
- Which of the investment strategies set out above has been used from 1999 (or later).

Once the trustees have identified the capital proportion of the mixed fund, the SPT will map its movement from 1999 (or later) to the relevant year. The balance of the fund will be treated as a mixture of income and capital gains. The net return percentage of the relevant investment strategy will then be applied to the balance based on the reference currency. For example, where an aggressive strategy was adopted, the non-capital proportion of the mixed fund will be treated as 75 per cent capital gains and 25 per cent income.

Trustees will not have access to the SPT, which will be maintained centrally by the LIT. The trustees will instead submit a request to the LIT, and it will carry out the calculations on behalf of the trustees at a nominal cost.

Alternatively, trustees will also have the option of calculating the constituent parts themselves where full records are available and the application of the SPT would be disadvantageous.

[9] The SPT will initially cover the years 1999 to 2017, with updates for subsequent years to follow.

Separating out the mixed fund into its constituent parts

Importantly, the proposal goes further than simply suggesting a pragmatic approach to calculations of capital, capital gains and income pools. In particular, the proposal seems to allow the trustees to separate out the mixed fund into its constituent parts.

Trustees who wish to use this unmixing opportunity must submit a written request to the LIT and pay a CHF 1,000 fee. The request must include the trust name, its legal domicile, the relevant investment strategy and reference currency as well as the "start date" (presumably, the date the trust was established). The trustees must also confirm that the entity or trust is managed in Liechtenstein. The LIT may request supporting documentation if required. The Liechtenstein Government will not legislate the procedure, which will instead be managed by the LIT.

Unlike the one-off HMRC relief for mixed funds held by individuals, the LIT segregation procedure is *not* a limited one-off opportunity.

It is also worth noting that:

- The procedure is optional: trustees who are already segregating income and capital or keeping adequate records may continue to do so and do not have to apply the SPT performance criteria; and
- The proposal confirms that distributions to UK beneficiaries from the trust will continue to be taxed in the UK in accordance with general principles. In other words distributions and other benefits will be taxed as and when they are matched against the agreed income and/or gains pools.

Practical implications

Allowing trustees to adopt a pragmatic approach to calculating income and gains pools is not unprecedented or necessarily surprising.

However, giving Liechtenstein trustees the ability to physically segregate mixed funds into their constituent parts is significant and could in certain circumstances have far-reaching implications. Although distributions to UK beneficiaries will continue to be subject to UK tax in accordance with general principles as and when they are matched against trust income and gains, segregating income in particular could nevertheless provide opportunities which would not otherwise have been available.

For example, if income can be segregated into a separate account, this income could be distributed to a non-UK resident beneficiary. If this was done, then it would be consistent with HMRC draft guidance published in 2012 (although never finalised) that such income would no longer be treated as "relevant income" for the purposes of assessing UK resident beneficiaries to tax under s.731 of the Income Tax Act 2007 (the "transfer of assets abroad" regime) when they receive capital distributions or other benefits from non-UK trustees. Alternatively, the income could be used to pay trust fees and other expenses which, similarly, would reduce the s.731 relevant income pool in accordance with the HMRC draft guidance. Without this unmixing opportunity this would not be possible where income has not been kept separate from the start.

In addition, keeping income separate may be beneficial for Liechtenstein trusts with RND beneficiaries who pay tax on the remittance basis, as it enables trustees to avoid inadvertently remitting non-UK source income to the UK, for example by making UK situs investments. This would result in the RND beneficiary paying income tax on the arising basis in respect of distributions received offshore that are "matched" against income that has been remitted by the trustees to the UK.

Finally, the transitional provisions introduced as part of the 2017 legislative changes were such that in certain circumstances pre-6 April 2017 foreign source income arising to a trustee could still be taxable on an RND settlor if remitted to the UK. This segregation opportunity would enable a Liechtenstein trustee

to segregate such income in order to minimise the risk of inadvertently remitting sums to the UK in circumstances which would trigger a UK income tax charge for the RND settlor.

It is less certain whether the trustee of a trust settled by an RND individual using funds which derive from the individual's foreign source income or capital gains can segregate the settled amounts into their constituent parts, thereby ensuring that the RND settlor's foreign source income and gains transferred to the trustee should not be inadvertently remitted to the UK. The proposal appears only to apply to trust profits, not the settlor's profits that were transferred to the trust. It would therefore be prudent to assume that this form of segregation would not be possible under these proposals.