DRAFTING TRUSTS - TAKING ON BOARD THE IMPLICATIONS OF THE BOTNAR CASE

by Nicola Shaw

The recent decision of IRC v. Botnar [1998] STC 38 marks a further tightening of the thumbscrews on offshore settlements and in particular has some important implications for the drafting of such settlements.

The Legal Matrix

The case concerned the application of s.739 of the Income and Corporation Taxes Act 1988 ("ICTA 1988") to income arising within an offshore settlement. Section 739 applies where:

(i) an individual transfers assets

(ii) with the result that income becomes payable to a non-resident but

(iii) the transferor has a "power to enjoy" that income.

Where these conditions are met, the income will be treated as the income of the transferor.

The part of concern in Botnar was whether the transferor had a "power to enjoy" the income within the wide definition in s.742(2) ICTA 1988.

The Factual Matrix

The taxpayer transferred some shares to a Liechtenstein settlement. Although he and his wife were expressly excluded from benefiting under the terms of the settlement, the trustees had a power to transfer the whole or part of the trust fund to other settlements. Clause 3(c) of the settlement provided that the trustees were to have power to:

> "Pay or transfer the whole or any part … of the capital of the trust fund to the trustees … of any other trust … under which any one or more of the members of the appointed class are interested notwithstanding that such other trust may also contain trusts, powers and provisions … in favour of some other person … and so that after such transfer the money, investments and property so transferred shall:
>
> (i) cease to be regarded as held upon the terms of this settlement; and
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> (ii) cease to be regarded as the trust fund or part of the trust fund of this settlement."

The taxpayer was assessed under s.739 ICTA 1988 on the income from the shares and appealed against those assessments.

The Decision

Evans-Lombe J. held that the power under Clause 3(c) (in conjunction with the excluded persons clause) was intended to make it possible for the whole or part of the trust fund to be resettled upon trusts under which the taxpayer or his wife could benefit. Thus despite their exclusion under the settlement, the potential for them to benefit under another settlement which

might receive funds from the settlement in question meant that they had a "power to enjoy" the income of a person resident outside the UK and thus the taxpayer fell to be taxed under s.739 ICTA 1988.

The Merits

The aim of s.739 ICTA 1988 is to prevent a taxpayer avoiding income tax by transferring an income-producing asset abroad on such terms that although the income accrues to a non-resident, the taxpayer can still receive the benefit of that income. It is a penal provision and thus is prone to strict interpretation and harsh application.

Despite that backdrop, at first glance the decision in Botnar seems unwarranted. On the face of the settlement, neither the taxpayer nor his wife could receive benefit - they were excluded persons. Therefore, one would think they fell outside the "power to enjoy" condition.

However, the layman would be forgiven for this view, and for failing to appreciate the full range of situations caught by the broad definition of "power to enjoy" in s.742(2) ICTA 1988. What sunk the taxpayer in the Botnar case was Clause 3(c) of the settlement which the judge held:

> "intended to make it possible to apply the trust fund by resettling part or all of it upon trusts which might include an excluded person as well as a member of the appointed class in its list of beneficiaries, so as to benefit Mr. Botnar or his wife in the future."
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> (page 88, g to h).

The clause was drafted so that the beneficiaries of the transferee settlement were not confined to the appointed class (and thus could include the taxpayer or his wife), and the property transferred would cease to be held under the terms of or regarded as part of the transferor's settlement (and therefore the beneficiaries under the transferee settlement would not be treated as taking any benefit under the terms of the transferor settlement). Therefore the taxpayer and his wife were held to be potential beneficiaries of the power contained in Clause 3(c) and thus had "power to enjoy" the income of a person resident outside the UK within the meaning of s.739(2) ICTA 1988.

Although the decision can be criticised on a number of grounds, such criticisms fall outside the scope and function of this article. Instead, I will try to highlight the pitfalls for those drafting similar settlements and in particular such settlements with a power to transfer funds to a new settlement.

The Pracital Implications of the Decision for Draftsman

The critical factor in Clause 3(c) of the settlement was that it gave the trustees the power to resettle funds on a trust with beneficiaries which had to include, but need not be limited to, at least one of the beneficiaries of the Botnar settlement. It was this which Evans-Lombe J held made it possible for the taxpayer and his wife to benefit.

However, as all draftsmen know, irrespective of this decision and putting the tax implications to one side, a power to transfer funds to a new settlement can have far-reaching consequences if drafted too widely. Most professionals consider that the new settlement should be defined as one under which the beneficiaries are restricted to some or all of the beneficiaries of the settlement from which the funds have been transferred. The importance of such a restriction on a practical level is to prevent the trustees having the authority to transfer the funds to an alternative settlement under which they benefit beneficiaries of their choice and not necessarily the choice of the settlor:

> "trustees are sometimes given power to transfer the trust fund to any settlement provided that one beneficiary of the present settlement happens also to be a beneficiary of the new settlement. That is equivalent to authorising trustees to add beneficiaries; a very serious proposition if the power is exercisable without restraint."
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> (Kessler, 'Drafting Trusts and Will Trusts').

On that basis alone, there is much to be said for ensuring that the recipient settlement under a power to transfer funds has the same class of beneficiaries (or a subset of that class) as the transferor settlement. What the decision in Botnar does is to increase the prudence of such draftsmanship on a wider level. Absent such measures, the draftsman not only gives the trustees a freer rein but also now attracts the attention of the Inland Revenue.

The decision also highlights the potential for the term "power to enjoy". Naturally, where there is an express provision for the settlor or his spouse to enjoy under the settlement, it would not be difficult to predict the application of s.739 ICTA 1988. It goes without saying that such express provision is easy enough for the draftsman to avoid.

It is not quite so simple where the "power to enjoy" has a less visible source. Obviously, the more difficult it is to anticipate the "power to enjoy", the harder it is to prevent it. However, the lesson to be learned from Botnar is that the settlor exclusion clause only goes so far in securing the tax efficiency of the settlement. It is now absolutely imperative that the draftsman ensures that any power to transfer funds to another settlement is bound by the excluded persons clause, such that it is impossible for the settlement funds to be transferred to another settlement under which a potential beneficiary could be the settlor, despite his exclusion under the transferor settlement.

Conclusion

The decision in IRC v. Botnar is a cautionary tale for all those advising on or drafting offshore settlements. The draftsman must anticipate and provide for any hypothetical or potential situation as a result of which the settlor or his spouse might derive a "power to enjoy". It is now essential to ensure not only that the settlor is excluded from benefiting **directly** under the settlement but also **indirectly** via the exercise of the dispositive powers of the settlement. If

the settlor and his spouse are excluded from benefiting under the terms of the settlement by virtue of the excluded persons clause and the dispositive powers of the settlement are expressly subject to and restricted by that clause so that it is not possible for an excluded person to benefit under the terms of any other settlement, then the settlement should fall beyond the parameters of the Botnar decision. Anything less now renders the settlor vulnerable to tax under s.739 ICTA 1988.

Of course, the draftsman will not be troubled if the taxpayer satisfies the s.741 ICTA 1988 exemption (essentially, can prove that the purpose of the settlement was not to avoid UK tax). However, given the strong presumption of tax avoidance with off-shore settlements, draftsmen would be advised to take their own precautions as recommended above.