

SUB-FUNDS – DEEM, DEEM, DEEM?

by Felicity Cullen

Many trustees hold settled property on trust for several beneficiaries or several groups of beneficiaries. In a large proportion of cases where there are several beneficiaries or groups of beneficiaries, the trust instrument (and instruments which are supplemental to it) will provide for assets attributable to specific beneficiaries or specific groups of beneficiaries to be held on discrete funds or sub-funds within the settlement. This sort of division of assets within a trust fund was not, until recently, addressed by the income tax and capital gains tax (“CGT”) regimes; and this led to a number of difficulties or irregularities which are not discussed in this note, but which included matters such as utilisation of allowable losses for CGT purposes and the application of the share identification rules.

In 2006, legislation was introduced which permits trustees of a settlement to elect for a fund or specified portion of settled property to be treated as a separate settlement for income tax and CGT (but not one or other) purposes. In essence, a sub-fund election may be made if (and only if) the four conditions set out below are satisfied on the specified date (i.e. the date on which the election is specified to take effect), and if conditions 2 to 4 are satisfied throughout the period from the specified date to the date the election is made. The conditions are as follows:

1. The principal settlement must not itself be a sub-fund settlement.
2. There must be some property comprised in the principal settlement.
3. Property must not be co-owned by the trustees of the principal settlement and the trustees of the sub-fund settlement.
4. Subject to certain exceptions, a person must not be a beneficiary under both the principal settlement and the sub-fund settlement.

The CGT legislation relating to sub-fund elections is in s.69A and Schedule 4ZA Taxation of Chargeable Gains Act 1992 (“TCGA 1992”) and the income tax legislation is in s.477 Income Tax Act 2007 (which, in essence, gives effect to Schedule 4ZA TCGA 1992 for income tax purposes).

The four conditions referred to above are derived from paras. 4 to 7 inclusive of Schedule 4ZA TCGA 1992. Paragraph 1 Schedule 4ZA TCGA 1992 provides as follows:

“The trustees of a settlement (the “principal settlement”) may elect that a fund or other specified portion of the settled property (the “sub-fund”) be treated, unless the context otherwise requires, as a separate settlement (the “sub-fund settlement”) for the purposes of this Act, and the election shall have effect.”

Paragraph 13 Schedule 4ZA TCGA 1992 provides that a sub-fund election may not be revoked, and paragraph 17 Schedule 4ZA TCGA 1992 provides as follows:

“The sub-fund settlement shall be treated, for the purposes of this Act, as having been created at the time when the sub-fund election is treated as having taken effect.”

Paragraphs 18-22 Schedule 4ZA TCGA 1992 - under the heading “Consequence of a sub-fund election” (under which para.17 also sits) - provide for the following matters.

1. Paragraph 18 contains rules for the purposes of identification of the trustees of the principal settlement and of the sub-fund settlement from the time at which the sub-fund election takes effect.
2. Paragraphs 19 provides that the sub-fund trustees shall be treated for the purposes of the Act as having become absolutely entitled, at the time when the sub-fund election is treated as having taken effect, to the property comprised in that settlement as against the trustees of the principal settlement. This creates (or possibly confirms) a deemed disposal under s.71(4) TCGA 1992 (or under s.80(2) TCGA 1992) on the date on which the sub-fund election is treated as having taken effect: para.20 Schedule 4ZA TCGA 1992.
3. If the trustees of the sub-fund settlement are treated, by virtue of para.19 Schedule 4ZA TCGA 1992, as having become absolutely entitled to money expressed in sterling, the trustees of the principal settlement are treated as having disposed of that money, and the trustees of the sub-fund settlement are treated as having acquired that money, for the purposes of the Act on the date on which the sub-fund election takes effect.
4. Paragraph 22 provides for the attribution of trust gains between the principal settlement and the sub-fund in accordance with s.90 TCGA 1992. It will be apparent that paragraphs 1 and 17 Schedule 4ZA TCGA 1992 have the effect that, for the purposes of TCGA

1992 a sub-fund is to be treated as a separate settlement, created at the time when the sub-fund election is treated as having taken effect. The consequences of this may, conceivably, go beyond those that are specifically provided for in paragraphs 18-22 Schedule 4ZA TCGA 1992. In particular, where – as is likely to be typical – the sub-fund election is made as regards a part of the assets in the original settlement in which an individual had an interest such as an interest in possession, the effect of the election must be that for the purposes of TCGA 1992, that individual's interest in possession becomes an interest in possession in the funds comprised in the sub-fund settlement.

Does it then follow first, that the beneficiary concerned has disposed of his interest in the principal settlement and acquired an interest in the sub-fund settlement and, secondly, that the application of the provisions of s.76 TCGA 1992 (Disposal of interests in settled property) and s.76A (Disposals of interest in settled property: deemed disposal of underlying assets) needs to be considered? For the purposes of analysis, the first question will initially be assumed to be answered positively, and the application of the specific provisions will be considered accordingly. The first question will then be addressed.

Section 76 TCGA 1992

It is clear that, in the circumstances postulated, there is not an actual disposal by the beneficiary concerned. Any disposal must, accordingly be a deemed disposal. On the assumption that there is a deemed disposal of an interest under a settlement, s.76(1) TCGA 1992 will not, in most cases, cause chargeable gains to accrue on the occasion of that disposal because the deemed disposal will be made by a person for whose benefit the interest was created or by another person who has not acquired nor derived his title from one who has acquired the interest for relevant consideration in money or money's worth.

Non Resident Trustees

The protection of s.76(1) TCGA 1991 will not, however, be available in cases where the trustees of the settlement have, at any time (including at the time of the deemed disposal) been neither resident nor ordinarily resident in the United Kingdom (s.76(1A) and (1B) and s.85(1) TCGA 1992).

Interests in Sub Fund Settlements

Nor will the protection of s.76(1) TCGA 1992 will be available as regards a disposal of the interest in the sub-fund settlement, if the beneficiary of the sub-fund settlement should, on analysis, be considered as having acquired that interest for a consideration in money or money's worth other than consideration consisting of another interest under the settlement. Given the

separate settlement treatment applied to the sub-fund it is not considered possible to argue that any consideration consists of another interest under the *same* settlement. More fundamentally, however, it is considered that, even if there is a deemed acquisition of an interest in the sub-fund settlement for the purposes of s.76(1) TCGA 1992, there is no basis¹ for deeming² that the interest was acquired *for consideration in money or money's worth* (which consideration could consist only of the interest under the principal settlement). The legislative silence on this point may be contrasted with, for example, para.9(1) of Schedule 4A TCGA 1992³ in which the character of a deemed disposal is spelt out in terms which include treating that deemed disposal as having taken place for a consideration specified as described in that provision. Reference may also be made to para.3 of Schedule 4A TCGA 1992 which is referred to below.

Section 76A TCGA 1992

Section 76A TCGA 1992 applies Schedule 4A TCGA 1992 in cases where there is a disposal of an interest in settled property. Schedule 4A applies, in essence, where there is a disposal of an interest in settled property for consideration; then, if various conditions are met, there is a deemed disposal of the relevant underlying assets (as defined) comprised in the relevant settlement. Where the relevant conditions are met on creation of a sub-fund settlement, Schedule 4A TCGA 1992 could apply to create a deemed disposal of the relevant underlying assets provided that there is a disposal of an interest in settled property for consideration.⁴

Paragraph 3 of Schedule 4A specifically determines whether a disposal is “for consideration”. It provides as follows:

“3(1) For the purposes of this Schedule a disposal is “for consideration” if consideration is given or received by any person for, or otherwise in connection with, any transaction by virtue of which the disposal is effected.

(2) In determining for the purposes of this Schedule whether a disposal is for consideration there shall be disregarded any consideration consisting of another interest under the same settlement that has not previously been disposed of by any person for consideration.

(3) In this Schedule “consideration” means actual consideration, as opposed to consideration deemed to be given by any provision of this Act.”

In the light of this definition there are at least two clear reasons for concluding that, even if a sub-fund election causes there to be a deemed disposal of an

interest in the principal settlement and an acquisition of an interest in the sub-fund settlement, that cannot be a disposal “for consideration” as defined in Schedule 4A TCGA 1992. First, as regards para.3(1) Schedule 4A TCGA 1992, there is no “transaction” by which the disposal of an interest in settled property is effected: it is not considered that a unilateral election can properly be characterised as a “transaction”. Secondly, as regards para 3(3) Schedule 4A TCGA 1992, no relevant consideration is deemed to be given on the making of a sub-fund election by any provision of TCGA 1992 (which would not, in any event, be material); nor is there any actual consideration because, in actuality, there is no change to the beneficiary’s interest as a matter of fact or general law. A third reason is provided by the application of the principles in *Marshall v. Kerr* [1993] STC 360 which are considered below.

The Assumed Disposal

For the purposes of the above consideration of ss.71 and 76A (together with Schedule 4A) TCGA 1992, it has been assumed that it must follow from the making of the sub-fund election and the rules deeming the sub-fund to be a separate settlement that a beneficiary will be deemed to have disposed of his or her interest in the principal settlement and to have acquired an interest in the sub-fund settlement. A fundamental issue is whether, notwithstanding the separate settlement treatment for the purposes of the Act (TCGA 1992), this is a necessary inference.

There may be at least two reasons for concluding that this is not a necessary inference. The first reason derives from the correct approach to deeming provisions as described by Peter Gibson J in *Marshall v. Kerr* [1993] STC 360 at p.366 (and approved by Lord Brown-Wilkinson at [1974] STC 638 at p.648-649):

“... I take the correct approach in construing a deeming provisions to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction. I further bear in mind that because one must treat as real that which is only deemed to be so, one would treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from do so.”

The reasoning might run as follows. Giving paras 1 and 17 Schedule 4ZA TCGA 1992 their natural meaning, and consistent with the policy of the Act and provisions of Schedule 4ZA, as ascertained from the provisions of

Schedule 4ZA, to treat a sub-fund election as creating a disposal of an interest in the principal settlement and an acquisition of an interest in the sub-fund settlement would lead to injustice and absurdity: it would mean (for example) that no settlement which had at any time had non-resident trustees could elect for sub-fund treatment without exposing the beneficiaries to the crystallisation of potentially chargeable gains on disposals of their interests (in addition to the crystallisation of trust gains on the trustees of the sub-fund settlement becoming absolutely entitled as against the trustees of the principal settlement). Although one must treat as real the division of the original settlement into a principal settlement and a sub-fund settlement for CGT purposes, a beneficiary's interest can simply be regarded as switching from an interest in one settlement to an interest in another, or the original interest can be regarded as terminating and a new one as commencing; disposals and acquisitions by beneficiaries are not incidents or consequences which inevitably flow from or accompany the division of the settlement for tax purposes.

The second reason (which also supports the first reason in terms of the policy behind Schedule 4ZA TCGA 1992) is that Schedule 4ZA TCGA 1992 contains the heading "Consequences of a sub-fund election"; and the express consequences listed in paras.17 to 22 inclusive TCGA 1992 are clearly intended to be exclusive so that no other (implicit) consequences follow or are deemed to follow.

It is considered that this reasoning is correct and that the contrary conclusion would be unsustainable in the Tax Tribunal.

¹ See the principles from *Marshall v. Kerr* [1993] STC 360 set out below.

² Deeming is necessary as there is, in fact, (as for general law purposes) no change in the beneficiary's interest.

³"(1) The deemed disposal shall be taken –

- (a) to be for a consideration equal to... market value; and
- (b) to be a disposal under a bargain at arm's length..."

⁴ It might be observed that this deemed disposal of underlying assets would give rise to gains which are potentially identical to those which arise on the occasion of the trustees of the sub-fund becoming absolutely entitled as against the trustees of the principal settlement, (and there would be points regarding sequence and priority to be considered). It is considered inconceivable that there could be a double charge under Schedule 4A and s.71 TCGA 1992 despite the circumstances that this scenario would not fall within the express provisions of para.10 Schedule 4A TCGA 1992 (avoidance of double-counting).