Converting trust losses into winnings

Personal tax

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Samara Goeieman considers the non-resident capital gains tax charge on trustees disposing of direct holdings in UK residential property

Key Points

What is the issue?

Capital losses arising to UK resident trusts can, in certain circumstances, be transferred to a beneficiary of the trust and used to off set gains arising on assets transferred to him from the trust. We ask when these rules can be applied to non-resident trusts.

What does it mean for me?

A number of conditions need to be satisfied for the benefi ciary to be able to claim the capital loss generated as a result of the appointment to him of the property, and to set it against the later gain arising on the future disposal of the same asset.

What can I take away?

The loss treated as accruing to the beneficiary must be claimed within four years aft er the end of the tax year in which the loss arose. For the avoidance of doubt, HMRC should be notified in writing.

Capital gains and capital losses arising to non-resident trusts were generally outside the scope of UK capital gains tax unti l 6 April 2015, when legislation introduced a non-resident capital gains tax charge on trustees disposing of direct holdings in UK residenti al property. The scope of the charge was extended by Finance Act 2019 to include direct holdings of UK non-residential property and also to gains on all UK property held indirectly through corporate bodies.

Capital losses arising to UK resident trusts can, in certain circumstances, be transferred to a beneficiary of the trust and used to offset gains arising on assets transferred to him from the trust. In this article, I look at the general rules for allowing losses to be transferred to beneficiaries, and also look at the specific circumstances of whether losses arising to a non-resident trust on the disposal of UK property can be transferred to a beneficiary of the trust. We consider these issues by examining the case of Mr Graham.

Example: Mr Graham’s trust

Mr Graham is tax resident in Monaco and is the sole beneficiary of The Property Trust (‘the trust’), which was created in 2005 by his non-domiciled father. All the trustees of the trust are resident in Monaco, so the trust is not resident in the UK by virtue of the Taxation of Chargeable Gains Act (TCGA) 1992 s 69. The trust owns a UK freehold residential property which is held for investment purposes.

In November 2017, the trustees of the trust decided to wind up the trust and exercised their discretionary powers to appoint the property absolutely to Mr Graham.

The appointment of the property to Mr Graham triggered a deemed disposal of the property by the trustees at market value (TCGA 1992 s 71(1)) and the disposal was chargeable to capital gains tax by virtue of TCGA 1992 s 14B, as it applied in the tax year 2017/18. The trustees were able to rebase the capital gains tax base cost of the property to the market value as at 5 April 2015 by virtue of TCGA 1992 Sch 4ZZB s 5.

The trustees filed a non-resident capital gains tax return declaring the market value of the property at the date of the appointment to be £2 million and its market value as at 5 April 2015 to be £2.45 million, claiming a capital loss of £450,000 as a result of the appointment. Mr Graham now wants to sell the property and has put it up for sale at £2.6 million, expecting to receive around
£2.5 million net of all costs. What will Mr Graham's tax liability be on the sale of the property?

Basic principles

Under basic principles, Mr Graham is liable to UK capital gains tax as a non-resident on the disposal of the property by virtue of TCGA 1992 s 1A(3). His capital gains tax base cost is the market value at the date of acquisition (i.e. £2 million) and so he will realise a taxable gain of around £500,000 on the disposal. Rebasing to April 2015 is not relevant as he acquired the property after 5 April 2015. The question I consider in this article is whether the capital loss of £450,000 arising to the trustees on the appointment of the property to Mr Graham is available to reduce his capital gain.

Prima facie, losses accruing to trustees on a beneficiary becoming absolutely entitled to trust property can, under certain conditions, be treated as accruing to the beneficiary instead of to the trustees. TCGA 1992 s 71(2)(a) states the following:

'The loss shall be treated, to the extent only that it cannot be deducted from pre-entitlement gains of the trustee, as an allowable loss accruing to the beneficiary (instead of to the trustee).'

The conditions

Four conditions need to be satisfied for Mr Graham to be able to claim the capital loss generated as a result of the appointment to him of the property, and to set it against the later gain arising on the future disposal of the same asset.

Condition 1: Absolute entitlement

The first condition is that the loss must arise as a result of the beneficiary becoming absolutely entitled to the property as against the trustees.

A person may become absolutely entitled as against the trustees in three circumstances:

(a) where a life interest ends and where there is no further life interest;
(b) where a contingent interest vests on the contingency being met; or
(c) where a resolution is passed by trustees of a discretionary trust to transfer property to a beneficiary.

When beneficiaries become absolutely trustees, the trustees are regarded as having disposed of that property immediately reacquired by them as nominees for the beneficiaries at its market value.

After a beneficiary is absolutely entitled to a trust asset, they, rather than the trustees, are required to return any capital gain, or to claim any capital loss from a later capital gains tax event relating to that asset.

In the case of Mr Graham, Condition C is satisfied by virtue of the resolution of the trustees to transfer the property to Mr Graham in November 2017.

Condition 2: Pre-entitlement gains

The second condition is that the loss must not have been used by the trustees against other gains. Capital losses arising to trustees must, if possible, be offset against any capital gains arising to the trustees in that same tax year. These are called ‘pre- entitlement gains’ (TCGA 1992 s 71(2A)).

Any excess of losses over the pre-entitlement gains will potentially be available to be treated as an allowable loss accruing to the beneficiary.

If the losses cannot be used in the tax year in which they arise, either by offset against pre-entitlement gains or by transfer to a beneficiary, they are carried forward in the trust to future years.

The trustees had no pre-entitlement gains in 2017/18, and so the whole of the loss arising on the disposal of the property is potentially available to Mr Graham.

Condition 3: Allowable losses

The third condition is that the loss accruing to the trustees must be an allowable loss. Generally, all losses accruing to UK resident trustees will be allowable losses, so the specific issue we need to consider here is whether the fact that the trust was not UK resident at the date of appointment of the property affects the position.

TCGA 1992 s 1E(1) defines when a capital loss is not an allowable loss as follows:

'A loss is not an allowable loss if it accrues in a tax year at a time when, had a gain accrued instead, the gain would not have been chargeable to capital gains tax under this Act for the tax year.'

If there had been a gain on the disposal, it would have been chargeable to capital gains tax for the year, and so this condition is not offended.

Sections 1E(2) and 1A(3) go on to state the position applicable to non-UK residents. Section 1E(2) states: 'In addition, the only allowable losses that qualify for deduction from chargeable gains under s 1A(3) (non-UK residents) are those accruing to the person on disposals of assets within that subsection.'

Section 1A(3) includes 'assets that are interests in UK land'. Therefore, in the case of Mr Graham, the loss accruing to the trustees is an allowable loss, regardless of whether or not the trustees were UK resident at the time of the appointment to Mr Graham.

Note that the loss would not be an allowable loss if it had accrued to the trustees on an appointment of the property prior to the date when disposals of UK residential property by non-residents became liable to capital gains tax. Similarly, losses accruing to non-resident trustees on disposals of assets that are not chargeable to UK capital gains would also not be allowable losses.

One should mention here that TCGA 1992 s 16A(1) prevents a loss being an allowable loss if it accrues to a person directly or indirectly in consequence of, or otherwise in connection with, any arrangements; and the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage. However, that seems to be of no relevance here.

Condition 4: Disposal of the same asset

The fourth condition is that the loss treated as accruing to a beneficiary can be used only to the extent that it can be deducted from gains accruing on a future disposal of the same asset. The loss can be used for no other purpose.

Section 71 (2)(b) states:

‘Any allowable loss treated as accruing to the beneficiary under this subsection shall be deductible under this Act from chargeable gains accruing to the beneficiary to the extent only that it can be deducted from gains accruing to the beneficiary on the disposal by him of:

1. the asset on the deemed disposal of which the loss accrued; or
2. where that asset is an estate, interest or right in or over land, that asset or any asset deriving from that asset.’

Mr Graham is disposing of the same asset as the one on which the original loss arose and therefore satisfies this condition. Indeed, all four conditions are satisfied and the loss arising to the trustees will be available to Mr Graham to reduce the gain arising on his future disposal of the same asset.

Making the capital loss claim

The loss treated as accruing to Mr Graham must be claimed within four years after the end of the tax year in which the loss arose. The loss arising to the trustees arose in 2017/18 and therefore a claim must be made by 5 April 2022, otherwise the losses will no longer be available.

It could be argued that the loss claimed in the non-resident capital gains tax report filed by the trustees is sufficient. However, for the avoidance of doubt, a letter claiming the losses should be sent by Mr Graham to HMRC by not later than 5 April 2022 (assuming that he has not already claimed the loss in his 2017/18 tax return).

Conclusion

Mr Graham assumed that he would have a large capital gains tax liability as a result of his proposed disposal of the property. However, on further research he has satisfied the conditions for the loss arising to the trustees to be available to him to reduce the gain arising. By carefully researching the roulette table of the tax legislation, Mr Graham has converted the trust losses into personal winnings.