PRACTICAL PROBLEMS OF TRUST ADMINISTRATION SINCE FINANCE ACT 1991

Philip Giddings

The 1991 Budget dealt non-resident trustees a series of blows long advocated by those without sufficient personal wealth to be concerned about capital gains tax. Those halcyon days where trusts could be exported without charge (except held-over gains), and then gains tax deferred on subsequent gains until beneficiaries received capital payments, were coming to an end.

The type of trust to suffer most was the one where a UK domiciled settlor or a member of his close family ("the defined class") could enjoy a benefit. In such a trust the gain was to be immediately taxed on the settlor. Were it not for the inclusion of adult children in the definition of the defined class this new rule had an element of fairness and similarity to income tax.

All new trusts of this type were immediately to be "qualifying settlements". An odd choice of words. Qualification usually brings rewards, not punishment. Thankfully, however, trusts in existence on Budget Day would not be qualifying settlements unless, put briefly:

1 Funds were added; or

2 The settlement was exported; or

3 The terms of the trust were varied to include as a beneficiary a member of the defined class; or

4 A member of the defined class who was not a beneficiary received a benefit for the first time.

Worries about numbers 2 to 4 have largely been dispelled by the final legislation and a subsequent Statement of Practice (SP 5/92). Most practical difficulties arise in respect of 1.

For the benefit of those who catch up on their reading while travelling, I repeat the relevant provision in full (TCGA 1992 Sch 5 Para 9(3), previously FA 1991 Sch 16 Para 11(3)) :

"(3) The first condition is that on or after 19th March 1991 property or income is provided directly or indirectly for the purposes of the settlement -

(a) otherwise than under a transaction entered into at arm's length, and
(b) otherwise than in pursuance of a liability incurred by any person before that date;

but if the settlement's expenses relating to administration and taxation for a year of assessment exceed its income for the year, property or income provided towards meeting those expenses shall be ignored for the purposes of this condition if the value of the property or income so provided does not exceed the difference between the amount of those expenses and the amount of the settlement's income for the year."

Practical problems of administering trusts arise from a mixture of the following :

The complete devastation effect.
Uncertainty of the meaning of the words used.
Lack of knowledge.
The absurdity of some of the concepts and implementation.
Memory failure.

1 The Complete Devastation Effect

The entire settlement will become tainted, i.e., will become a qualifying settlement, if any amount no matter how small is provided for the purposes of the settlement unless it comes within the terms of the provisos. I was shown a draft income statement for one settlement which revealed the following (the figures and detail have been simplified to assist non-accountants):

Bank interest	£4
Less bank charges	£5
Amount charged to life tenant's account	£1

In other words the life tenant was being asked to contribute £1 from money previously due but not paid to him. Now banks, or at least in their minds, have good reason to charge bank charges and I was somewhat mystified as to why on such an inactive settlement any amount had been charged. So I made due enquiry and was told that the bank charges were in respect of safe custody charges for holding the share certificates and trust documents. The charges should of course have been charged to the trust fund. There was nothing wrong with the life tenant contributing the £1 as that was the amount by which administration expenses exceeded the trust income. However, the life tenant should not have suffered the other £4. The draft statement was duly amended. Now obviously there would have been arguments that the life tenant was not aware that he should not have suffered the bank charges and therefore had not been providing property for the purposes of the settlement. But if he had known then this minute addition to the settlement would have irretrievably tainted the settlement.

There have been instances where proposed commercial transactions have had to be reconsidered or even abandoned by the trustees because of fear that the Revenue could argue that there had been a provision of the property for the purposes of the settlement even if the quantum of the additional property was minute. What is clearly lacking from the legislation is a *de minimis* provision. It is a misuse of both the professional tax adviser's time and also the Inland Revenue's time to have to scrutinise all trusts and all transactions for this amount of detail.

2 Uncertainty of the Meaning of the Words Used

Many of the words used and the Revenue interpretation of them are open to challenge. Our policy, however, in view of the complete devastation effect, is to avoid problems if at all possible. Therefore, if there is even the worry that the Revenue might interpret the words in a particular adverse way, then we have to find other ways of achieving the overall desired result.

The first word in doubt is "indirectly". The safe view is that this includes property or income provided, for or even services provided to, an underlying company if not on fully commercial terms. This interpretation is, however, not beyond challenge where the company does not actually have to account to the trustees for what it has gratuitously received.

"For the purposes of the settlement" are the next words requiring scrutiny. It is accepted by the Revenue that for the provisions to apply bounty must be present. In complex commercial situations it can sometimes be far from clear why apparently bountiful acts have been carried out. In particular, difficulties arise where beneficiaries are directors of underlying companies. It is not unknown for directors to make interest-free loans or work for less than full market rate in such circumstances. Apparently, however, where this act of bounty is directed only at the company, such as an interest-free loan to assist the company over a temporary cash shortage problem, tainting will not occur. I prefer to look for ulterior motive. If the long term success of the company depends on the director working short term for less than commercial rate but he will subsequently be properly remunerated, then he may well agree to such an arrangement to ensure his future employment.

The words within (a) and (b) leave a lot to be desired in the drafting but the Revenue have adopted practical approaches and those of us content to rely on Revenue practice rather than arguing over the precise meaning of words do not have difficulty. Any doubts as to whether a proposed transaction is in fact being entered into at an arm's length price may be overcome by the use of an appropriate price adjustment clause. In many instances the price adjustment clause is longer than the main substance of the contract.

Finally, notwithstanding the Statement of Practice, the words "expenses relating to administration" cause difficulty. The Statement of Practice contains the following (paragraph 26):

> "The following items are not regarded as "expenses relating to administration" within the terms of the proviso to paragraph 9(3):
>
> - loan interest (other than interest on a loan taken out to meet expenses of administration within the terms of the proviso);
> - the costs of acquiring, enhancing or disposing of an asset;
> - expenses incurred in connection with a particular trust asset to the extent that such expenditure can be set against income arising from that asset. For the purpose of the proviso to paragraph 9(3), the measure of the gross income from such a source is net of expenses."

The difficulty now is whether that list is meant to be exhaustive. In one particular case the trustees had incurred expenses in connection with the proposed sale of certain assets but the sale did not take place. The expenses were strictly not expenses of disposing of an asset. Nevertheless, Counsel has advised that the expenditure was not an expense relating to the administration of the trust.

3 Lack of Knowledge

A problem closely allied to some of the problems dealt with above relates to the activities of underlying commercial companies. In many instances the trustees may well not be aware of all transactions or proposed transactions between directors and the company. It is very difficult to give advice on these provisions where all the facts are known. Where the facts are not known there is no hope.

4 The Absurdity of Some of the Concepts and Implementation

Trustees were of course very pleased to find relief provided so that their fees could be paid on dry trusts. The absurdity of the relief, however, is that expenses are always compared with income. This is regardless of whether or not the expenses are actually chargeable against income. It is regardless also of whether or not a net balance of income could be used to defray expenses chargeable to the trust fund or whether such income has to be paid over to the life tenant. In the example given in 1 above, the £1 could be added to the trust fund as that is the arithmetic difference between income and expenses. On the other hand, the remaining £4 could not be added but instead the life tenant or anyone else could lend that money to the trustees. The money then lent to the trustees would have to be at a commercial rate of interest. Interest would have to be paid thereon at least annually so that the loan itself was not constituting property provided for the purposes of the settlement. In many cases the trustees are unlikely to have any income to pay interest and the trustees will therefore have to borrow from the life tenant or whoever to pay the interest. That new loan will itself generate yet more interest, and so on. Except in the cases on which we are on fixed fees we should perhaps be grateful for all the extra time costs generated simply in paying ourselves. Whether or not they are recoverable is another problem.

My favourite absurdity is, however, with regard to payment of tax. The Revenue accept that a capital gains tax liability which arose on export during 1989/90 was a liability incurred before Budget Day. Therefore, as a result of (3)(b), the settlor could add funds to discharge that liability without the need to look at the level of income. However, if the trustees do not discharge the assessment the Revenue have the right to assess the settlor direct (FA 1981 s.79(7)). If the settlor then pays that assessment he has the right of recovery against the trustees (FA 1981 s.79(9)). If he does not exercise that right he will be providing property for the purposes of the settlement and the first condition will be breached. It seems absurd that the settlor can add money to a settlement to discharge the trustees' liability without harm but harm will be caused if he discharges a new assessment on himself. The right of recovery is itself an area of difficulty, as in all probability the Jersey court would not assist the settlor.

5 Memory failure

The day to day activities of trusts administered by us are dealt with by trust administrators and not by tax specialists. It is hard enough for tax specialists to understand and remember the problems with the legislation. To expect administrators to remember all the problems is unrealistic.

Administrators familiar with the old rules in FA 1981 s.80 have for years worked on the basis that there can be no harm caused by the setting up of a settlement by a non-domiciliary or the adding of property by a non-domiciliary to a settlement.

Some administrators therefore find difficulty in remembering that any trust to which property is now added will be tainted. It is irrelevant whether or not the settlor is currently domiciled and resident in the UK. If the settlor is so domiciled and resident when the gain is realised, then any addition now will cause harm.

Conclusions

I do not believe Parliament intended to make administration of existing non-resident trusts so difficult. It was obviously necessary to ensure that existing trusts should not be used in cases where new trusts would be caught. The complete devastation effect, however, means that trustees must be extremely cautious so as not to cause tainting of a settlement. A much more reasonable approach for the draftsman would either have been to have introduced segregation rules so that additional funds would be treated as separate settlements. Alternatively *de minimis* rules should have been introduced so that undue attention need not be given to petty amounts. Perhaps also a clearance procedure for proposed transactions would have been worthwhile.

As it is, extreme care is necessary for all those administering non-resident trusts.