KEY HIGHLIGHTS OF "TRUSTS AND TAXATION POST FINANCE BILL 2005"

A Double Silk Seminar held on 8th June 2005

Speakers:
Robert Venables QC ("Robert")
James Kessler QC ("James")

Reported by:
Ralph Ray[1]

The Three 2005 Finance Bills and Recent Cases Review

- *The Three Finance Bills* were referred to by Robert.

- *West v Trennery* [2005] United Kingdom HL 5 [2005] STC 214

A flip-flop involving a United Kingdom resident trust. The best possible facts were selected from Revenue's point of view. The statutory basis: Taxation of Chargeable Gains Act 1992 Act section 77 (as substituted by Finance Act 1995 and as amended at 1st March 2005).

Lord Walker gave the longer lead speech, but all the judges also agreed with Lord Millett, as well as Lord Walker.

It seemed completely obvious to their Lordships that money in fact contained in the first settlement and which had, as a matter of history, been raised by a mortgage of the shares comprised in the first settlement, represented those shares and that those

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shares were comprised in the first settlement. (It is not clear from the speeches to what extent Counsel for the taxpayer argued the contrary). The only argument, so far as appears from the speeches, was whether, in order to constitute "*derived property*", the money had still to be contained in the first settlement. This did not seem at all obvious to Robert!

Suppose the property comprised in the first settlement had been a freehold and the trustees had, in exercise of their administrative powers, granted a lease to an unconnected third party for a market value premium and then, in exercise of their dispositive powers, appointed the proceeds to the trustees of a second settlement. The property transferred to the second settlement represents the proceeds of property which was formerly settled property comprised in the first settlement but does not represent property *still comprised* in the first settlement. It represents the lease, which belongs to the third party. It would represent part of the unencumbered freehold which had *historically* been comprised in the first settlement, namely the freehold reversion. For the lease and the freehold reversion are quite separate assets. What is left in the first settlement represents, together with the lease and/or the proceeds of the lease, the other part of what was originally contained in that settlement, namely the unencumbered freehold. Neither the lease nor the proceeds represents the freehold reversion and the freehold reversion does not represent the lease or the proceeds of the lease.

Robert asked the delegates to consider the position where the trustees of the first settlement grant, in exercise of their dispositive powers, to the trustees of the second settlement a beneficial lease of that property, say for 99 years at a ground rent. Would the lease be derived property in relation to the property which remained comprised in the first settlement? No, Robert contended, for the same reasons.

Robert also considered the position where the trustees of the first settlement raise money on mortgage of the freehold and, in exercise of their dispositive powers, appoint the money to the trustees of the second settlement. The money appointed represents the mortgage, i.e. the rights of the mortgagee. That is not property comprised in the first settlement. What is comprised in the first settlement is the equity of redemption, i.e. the property *subject to* the mortgage. The mortgage, far from being property comprised in the first settlement, is something taken out of that property! The analogy with the freehold out of which the lease is charged is almost perfect.

Does the decision catch all flip-flops involving United Kingdom resident trusts, Robert asked. What if there were no mortgage? To what extent is it overtaken by Finance Act 2000, which introduced into the Taxation of Chargeable Gains Act 1992 Act a new s.76B and Sch 4B "tailor-made to frustrate the scheme which the

taxpayers used in this case"? See per Lord Walker at paragraph 24.

Robert also emphasised that the relevant statutory wording for non-UK resident trusts is different and is without the emphasis on "derived property" – see TCGA 1992 s.86.

- In relation to *Howell v Trippier* [2004] STC 1245, and generally, Robert warned of the possible drawbacks of the *Leapfrog Procedure* to the Court of Appeal under TMA 1970, s. 56A. The composition of that court could be to the taxpayer's disadvantage!

- As to *Jones v Garnett* (HMIT) 2005 EWHC 849 (Ch) involving companies and settlements for income tax purposes, the settlement being one under which the spouse enjoys income on a gratuitous basis. Robert feels this case has been correctly decided, i.e. to the taxpayer's disadvantage.

Trusts for Vulnerable Beneficiaries – How to Secure Favourable Treatment for IHT, CGT, And Income Tax – a subject considered by James.

There are now five tax reliefs for disabled beneficiaries:

(1) IHT dependent relative relieve – s.11(3) IHTA 1984

(2) IHT deemed interest in possession – ss.89 and 3A IHTA 1984

(3) CGT full annual allowance – s.38 Sch 1 TCGA

(4) CGT holdover relief – s.169D TCGA

(5) Trust Tax transparency – ss. 45, 37, 38 FA 2005

Each has different requirements as to disability and drafting.

The IHT and CGT conditions are the same as regards the condition that the property must be held on trusts which secure that not less than half of the settled property which is applied during the disabled person's life is applied for his benefit. Unfortunately, another condition under which during the life of a disabled person, no interest in possession subsists is clearly incompatible.

All trusts qualify for a *CGT annual allowance*. Normally this is set at one half the amount of the individual's allowance (2005/06 £8,500 ÷ 2 = £4,250). A CGT disabled person's trust enjoys the full and not the half allowance. This tax advantage is therefore worth about £1,500 in a year which a trust realises capital gains. It is not a very significant tax relief.

The conditions for the Trust Tax transparency in FA 2005 are as follows:

(1) *Disability requirement*: The beneficiary must be mentally or physically disabled. This condition is the same as that for the full CGT annual allowance, except that the condition need only be satisfied at the time of the gift to the trust.

(2) *Drafting requirement*: The property must be held on trusts

a. under which, during the life of a disabled person, no interest in possession in the settled property subsists, and

b. which secure that not less than half of the settled property which is applied during his life is applied for his benefit.

Condition (b) is the same as the CGT condition. Unfortunately, condition (a) is different and must be satisfied throughout the beneficiary's life. The condition is therefore usually incompatible with the condition for a CGT Disabled Person's Trust.

Trust Tax transparency

The FA 2005 introduced an extraordinarily complex code of IT and CGT relief for two types of trust: certain trusts for disabled beneficiaries and for orphans. The relief for the two types of trust are the same, but the requirements are entirely different.

Elections and Notices

Two elections are required for the reliefs to apply: a vulnerable person election (made once) and an annual claim by the trustees (made in their tax return). The vulnerable person election is (technically) irrevocable but since it is supplemented by an annual claim, the relief is effectively an optional one. A vulnerable person election without an annual claim is of no effect.

Nevertheless, if a vulnerable person election is in effect, trustees must inform the Revenue within 90 days if:

- the person ceases to be a vulnerable person;
- the trusts cease to be qualifying trusts; or
- the trusts are terminated.

James deplored the complexity for a system hardly likely to be used for tax avoidance. He instanced elections (two) and notices requirements, strict time limits, relief for orphans special rules, and the complex calculation formula. This formula in s.26 FA 2005 is further likely to reduce claims to a trickle.

The relief is, in short, that trustees will pay tax at the rate applicable if the beneficiary had received the trust income and gains. The tax saving *could* be as much as £5,000 per year, but it will generally be far less than that, and after allowing for the professional costs involved, James was doubtful there would be any overall saving. A claim can actually increase tax liabilities:

(1) if the individual realises gains of his own, because the trust loses its CGT annual allowance if a claim is made; or

(2) because of the disregard for individual reliefs in certain circumstances.

Disabled beneficiaries: James' conclusion: How then should one provide for disabled beneficiaries?

Small funds

The amounts involved may be too small to justify a trust. The best course then must be to seek a suitable individual who will take the funds and (without obligation) use them for the beneficiary.

If no suitable individual is found, a scheme operated by MENCAP (www.mencap.org.uk) may be considered. Under this scheme an individual creates a discretionary trust, with a nominal trust fund, and bequeaths additional funds by Will. A MENCAP company acts as trustee. MENCAP only administers trusts set up under its standard form and does not act with co-trustees. Charges are raised on a non-profit making basis. Administrative costs should therefore be less than for comparable private trusts.

Substantial funds: provision by Will

The uncertainties are so great that the most sensible form of Will must be a **discretionary** Will Trust: this course allows the important decisions to be deferred until after the death of the testator.

Substantial funds: lifetime provision

Where sums involved are within the IHT nil rate band (or twice that amount, if husband and wife are making gifts), then the best course would be to make a gift to a discretionary trust.

Where sums involved are large, and means tested benefits not a consideration, the best course will generally be to create an interest in possession trust.

James considered that it is possible to envisage circumstances where the IHT deemed interest in possession trust is the most suitable form of trust, but in practice, he felt this is not often likely to be the case: only where a trust has a beneficiary with a good life expectancy, claiming benefits, where the fund is so large that ten year charges are a serious burden. Where the settlor cannot expect to survive seven years, the gift should be made so as to qualify for IHT dependent relative relief.

What is needed is a single, coherent set of rules for IT, IHT and CGT. James had hoped that this might emerge from the current review on the taxation of trusts! Instead we have a textbook example of disproportionate complexity arising from well meant tinkering.

The New Regime for the Taxation of Trusts was analysed by Robert.

- Robert reviewed recent developments:
    - Mini-Budget 10 December 2003 Announcement. "Tax avoidance".
    - "Modernising the Tax System for Trusts" – four discussion papers 11/18 December open-ended papers intended to stimulate debate"
    - Latest Consultation Document August 2004

- Draft clauses (for insertion in Finance Act 2005) were promised later in 2004.

- Budget Speech March 2005 Announcement

- Only provisions on trusts for vulnerable individuals and lower rate band were included in Finance Act 2005. (Vulnerable individuals retrospectively to 2004/05).

- Further discussion will follow. Main provisions are now likely to be introduced as from 6th April 2006.

- Income Taxation of Trustees – Robert reviewed the current position.

1) Generally

Trustees are in general liable to income tax at the "ordinary rate" (basic, savings or dividend ordinary rate) depending on type of income. Trustees may also be liable at the higher rate (the rate applicable to trusts/the dividend trust rate). Special rules for non-resident trustees can apply. Sometimes the liability is the trustee's own definitive liability. Sometimes it is a representative liability on behalf of a beneficiary. Trustees are liable to report that they have taxable income and to make returns. It seems therefore: no change (except as regards bare trusts).

2) Interest in Possession Trusts

Under a trust governed by English law or some similar proper law identical in this respect, the beneficiary is entitled to the income itself as it arises, subject only to lien for trustees' expenses properly chargeable to income. The source of the beneficiary's income is the same as that of the trustees. There is no fiscal alchemy. *Baker v Archer-Shee*. The fact that the income is the beneficiary's may alter its taxability. *Williams v Singer*.

Insofar as the beneficiary is entitled to the income, the trustees are not, and they will thus be taxable, if at all, in a representative capacity at a rate no higher than the ordinary rate. Where tax is deducted at source or where the income comes with a tax credit for ordinary rate tax (as in dividend and dividend-type income), the trustees will not in fact have to dig into their pockets to pay the tax.

Insofar as the trust income is used to defray trust expenses it will not belong to the beneficiary, it will be chargeable at only the ordinary rate.

Problems arise with interest in possession trusts where the statutory income is not the same as the trust income. Typical cases involve taxation the preceding year basis and the effect of capital allowances and balancing charges.

Robert feels no major change in general, but much will depend on the precise wording of Finance Act 2006. The new rules could well result in "notional income" (e.g. balancing charge) being taxed at 40% rather than at the ordinary rate. A difficulty could exist where trust's real income and beneficiary's real income are different from taxable income.

3) Non-interest in Possession Trusts

The general rule is that the income of the trustees is currently taxable at the RAT (40%) if

(a) Taxes Act 1988 s.686 applies; or

(b) some other provision expressly subjects it to charge at that rate.

In any other case, the income is taxable (if at all) at the ordinary rate.

Court of Appeal has decided in *Howell v Trippier* that the income is taxable at the RAT. The trustees have petitioned for leave to appeal to the House of Lords.

As to *Distribution of Trust Income* see Taxes Act 1988 s.687 (Payments under discretionary trusts). If trustees receive £1,000 of interest (formerly, Schedule D Case III) income on which they are taxed at 34%, and then distribute to a beneficiary the £660 post-tax income, they are deemed to pay him £1,000 from which £340 tax is deducted. As the £340 is covered by the tax they have paid, they do not have to account for it. The beneficiary is treated as receiving £1,000 under deduction of 34% tax. He is normally liable to pay or entitled to a refund depending on his personal

circumstances.

4) Change Effective 6th April 2004

40% rate is not yet extended to all trust income. Instead, the rate applicable to trusts is 40% (instead of 34%), as is the rate at which trust capital gains are taxed (after allowing for a modest annual exemption).

Robert considers this rate is penal. It is the highest rate at which any individual is taxed. Income will often be accumulated within a trust at a rate greater than that which would have been borne by the beneficiaries. There may be marginal cases in which trust income suffers a smaller liability to NI contributions than if it had arisen to an individual. Section 687 payments will be made under deduction of tax at the 40% rate. The tax pool will become exhausted more quickly and the beneficiary will be able to reclaim greater tax or be liable to pay less tax *unless* trustees diminish the size of the net payment.

What is likely to happen as from 2006/07? The August 2004 "Consultation Document" has firmed up on many features. But we still do not have draft clauses.

Rate: It seems very likely that the 40% rate will be extended to all trust income, at least in the first instance and if there is no beneficiary entitled for an *interest in possession*. The first £500 of taxable income after streamline deduction (see below) and expenses of management deduction will be taxed only at the ordinary rate (basic, lower or dividend ordinary).

Section 686(2): The old distinction whereby s.686 etc applied only to certain types of undistributed income will be swept away. Income which is capital for trust purposes and notional income will be taxed at this rate too. It will be impossible to reduce the rate by distributing it to a beneficiary. Hardship could result. The treatment of income used to defray trust expenses may be different but it currently is problematic. In Robert's view, there is no reason why all expenses of management should not be deductible as regards all rates of tax. This is most unlikely to happen.

Section 687 and Streamlining: Where income is "rapidly" passed to beneficiaries, the trustees will be liable, in a representative

capacity, at the ordinary rate only. Beneficiary's income will be same source as trustees'. This should overcome the problem with lost dividend tax credits. Income must be so passed by 31 December following year in which income arose to trustees. Income will be income of beneficiary in year of receipt, if later than year of payment. An opportunity for deferring tax on difference between ordinary rate and upper rate for one year.

Some extra scope for utilising beneficiary's reliefs:

- For some unaccountable reason, there will be no income streaming of taxable income which is not income for trust purposes. Why not?

- Trustees will probably be liable in representative capacity at the ordinary rate, but this will be reclaimable by the beneficiary in an appropriate case.

- Where income distributed too late for income streaming to operate, it seems that the beneficiary will not be taxed at all on receipt. However, there are indications that it will be treated as his taxable income but that he will receive a 40% non-repayable tax credit. This could make a difference in the case of top-slicing provisions. (It is clear from 7.18 of the TCD of August 2004 that this has not been appreciated!).

- Watch the case where the beneficiary is in receipt of a fixed or discretionary annuity.

- Unless express change made to inheritance tax legislation, the payment by the trustees of income which is still income (i.e. has not been accumulated) will not give rise to an exit charge. Nor will it be treated for inheritance tax purposes as a gift by the settlor.

Normal Rate Band for Discretionary Trusts: This will be worth a maximum of £500 × (40% – 20%) = £100 pa as compared with 2004/05.

Trust Management Expenses: "Widespread confusion" is alleged by the Revenue, e.g. trustees fees. The threat is: statutory codification! The Revenue seemed keen to extend the definition of "settlor interested" trusts. Although that can only decrease the rate of tax where income is

accumulated, the position may be different where income is distributed. In the case of wealthy families, the provisions just cause enormous complication but result in no more tax being charged.

Corporate Settlors: Robert posed the question: "Is it possible to get round the Income Tax settlor-interest test by using a company to settle the assets?"

Bare Trusts: It seems that capital gains tax treatment will apply for income tax purposes, i.e. trust will be looked through. Trustees would not be liable even in a representative capacity. An improvement, in Robert's view!

- Capital Gains Tax

Present Position: Trustees liable at RAT on trust gains realised by them (with modest annual exemption if not settlor-interested). If TCGA s.77 applies, settlor chargeable on amount of gains on which trustees would otherwise have been chargeable. Settlor entitled to indemnity from trustees. Settlor not deemed to own the settled property or to realise any particular gain. Losses of trustees can reduce s.77 gains but cannot be set against settlor's personal gains.

Gift in settlement is a disposal for capital gains tax purposes as is beneficiary becoming absolutely entitled to settled property. Any reliefs due to trustees are calculated in normal way, e.g. principal residence relief available is property to occupied by beneficiary who is not the settlor.

Settlor Interested Trusts – Proposals: A radical proposal which appears to treat the trust as non-existent, except for returns and liability, has apparently been rejected. Instead, the present position is to be retained but with the inclusion of the minor children test used in the income tax legislation. Settlor's losses can be offset against trust gains, but not vice versa. Putting assets into settlement would still be a disposal and acquisition.

Non-Settlor-Interested Trusts: Passing Gains to Beneficiaries. Proposal rejected – Why, asks Robert?

- **Definitions**

Definition of "Trust" : There will be a new general definition of "trust" which will apply for income tax and capital gains tax purposes, namely that of

"settlement" contained in Inheritance Tax Act 1984 s.43(2)!

Definition of "Settlement": The much wider definition of "settlement" in Taxes Act 1988 s.660G will remain as an anti-avoidance definition, as will the various CGT anti-avoidance definitions.

Definition of "Residence": Having regard to the different CGT and income tax tests, Robert considers the likely test will be "place of general administration"/"effective management or control and management".

- *Action to be taken* – Robert made various suggestions in appropriate circumstances:
  - It may be advantageous to realise certain gains/income before 6th April 2006, if they will not be subject to the RAT in 2006/07;
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  - Termination of Trusts in whole or in part?
  - Conversion into interest in possession trusts?
  - Streamlining? Consider in particular streamlining for minors by exercise of a power of appropriation
  - Possibly going non-UK resident?
  - Creation of Underlying Company? Income and capital gains could be sheltered at rates of between 0% and 30% (depends on extent to which, if any, company pays tax at small companies rate). If income or capital gains are distributed, there could be a further charge to Dividend Higher Rate at maximum of 25% of amount distributed – and potentially less if dividend is streamlined. If shares in company are disposed of, could be a charge to capital gains tax at rate between 10% and 40% in addition to corporation tax paid by company.
  - Income profits could be better than capital profits. Always enquire what is possible as a matter of *trust law*!

Trusts and Will Drafting in the Era of Civil Partnership - James Kessler QC

- Outline of Civil Partnership Act 2004

The Civil Partnership Act comes into force on 5 December 2005 allowing the first partnerships to be formed on 21 December 2005.

Section 1 Civil Partnership Act provides:

A *civil partnership* is a relationship between two people of the same sex ("civil partners") –

(a) which is formed when they register as civil partners of each other -

  (i) in England or Wales (under Part 2),

  (ii) in Scotland (under Part 3),

  (iii) in Northern Ireland (under Part 4), or

  (iv) outside the United Kingdom under an Order in Council made under Chapter 1 of Part 5 (registration at British consulates etc or by armed forces personnel), or

(b) which they are treated under Chapter 2 of Part 5 as having formed (at the time determined under that Chapter) by virtue of having registered an overseas relationship…

A civil partnership ends only on death, dissolution or annulment.

Section 3 Civil Partnership Act provides:

(1) Two people are not eligible to register as civil partners of each other if -

  (a) they are not of the same sex,

  (b) either of them is already a civil partner or lawfully married,

  (c) either of them is under 16, or

  (d) they are within prohibited degrees of relationship.

Good effects:

- The IHT spouse exemption will apply. Note, however, *Holland v IRC* [2003] STC (SCD) 43, a startling test case in which a cohabitee contends that she should be entitled to the IHT spouse exemption under *Human Rights principles*, discrimination between married and unmarried couples being in breach of Article 14 ECHR (Prohibition of discrimination). If ultimately successful – and the prospects of success seem greater than before – the consequences for the tax system will be of volcanic proportions. It will need several further cases to determine the various human rights issues. What about a same sex couple who have not entered into a civil partnership? What about a married man separated from his wife and living with another "as man and wife"? What about the settlement provisions? Where will it stop?

- Transfer of assets between civil partners who are living together will be on a no gain no loss basis for CGT.

Bad effects:

- The civil partners will only be entitled to one private residence for private residence relief.

- The civil partners will be "connected persons" for tax purposes.

Settlement provisions:

- The civil partners will be treated as spouses for the purposes of rules taxing settlors when their spouses have an interest. Consider the implications of *Jones v Garnett*.

- Effect on Drafting Trusts and Will Trusts – Wishes of Settlor/Testator

The terms of a trust or Will are a matter for the settlor to decide, and the drafter should obtain and follow instructions. However, it is thought that the better course (for IHT planning), and the more commonly desired course, would be to treat civil partners in the same way as spouses.

James referred to various other complications which will, at an appropriate stage, need to be taken into account, e.g. settlor exclusion clause; capital sums paid to settlor etc; also in relation to non-resident trusts; the Will Act 1837 as amended, e.g. revocation by civil partnership.

- Drafting Trusts and Will Trusts (7th Edition 2004) includes the following precedents for Will Trusts:

    1. Discretionary Will Trust

    2. Life interest for surviving spouse

    3. Life interest for surviving spouse with absolute gift of nil rate sum

    4. Life interest for surviving spouse with nil rate band discretionary trust

    5. Nil rate band discretionary trust; residue to surviving spouse absolutely

    6. NRB discretionary trust; residue to:

        (1) surviving spouse absolutely

        (2) discretionary trust (if no surviving spouse)

    7. NRB discretionary trust; residue to partner (not spouse) absolutely.

    Will forms 2 to 6 will be appropriate for a testator who is a civil partner replacing the word "spouse" and wife/husband with "civil partner".

- Civil Partners in class of beneficiaries

In the definition of the class of beneficiaries, spouses of children and descendants of the settlor are usually included. If so, civil partners of the children and descendants should likewise be included.

Taxation of Non-UK Residents – Robert concentrated on the aspect of:

Round the World Schemes**:**

- Before 16 March

If gains are as yet unrealised but are likely to be realised by a sale or transfer of assets to beneficiaries, it is possible in principle for the trustees to emigrate to a jurisdiction which has a double taxation convention with a suitably worded capital

gains tax article. One would ensure that the trustees would be residents of that jurisdiction for the purposes of the convention and thus any gains they realised would be exempt from United Kingdom capital gains tax.

It is essential that the trustees become United Kingdom resident before the end of the year of assessment, so that Taxation of Chargeable Gains Act 1992 s.87 (and 86) will not apply to the trust gains for that year. If the settlor or his spouse has an interest in the settlement, Taxation of Chargeable Gains Act 1992 s.77 would in principle apply to the trustees' gains for the year. In Robert's view, the settlor indirectly obtains the benefit of the trustees' immunity from capital gains tax.

Once the gains have been realised tax-free, they can be distributed to beneficiaries free of charge to tax. The scheme will not of itself prevent a recipient beneficiary being charged in respect of prior s.87 gains (or under ICTA 1988 s.740 or the Offshore Funds legislation). Inheritance tax on any distribution also needs to be considered.

- Finance (No 3) Bill 2005 Clause 33 [Now, Finance (No. 2) Act, section 33]

Clause 33 inserts a new s.83A in the TCGA 1992. It applies to disposals made on or after 16 March 2005. It provides for treaty override to deny exemption from liability to capital gains tax under a DTT if (a) the trustees "are within the charge to capital gains tax in that year of assessment" and (b) are non-UK resident at the time of the disposal. The treaty override applies not only to a charge on the trustees but on any other person. (The settlor is the obvious person).

In respect of countries within the EU, are such override provisions illegal?