FUNDAMENTALS OF THE INCOME TAXATION OF TRUSTEES AND BENEFICIARIES

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1 Principles of Liability

It is established that trustees are liable to income tax, at the basic rate, on so much of their trust income as does not belong in equity to a beneficiary.[2]

Trustees may also be taxable in a representative capacity on income to which beneficiaries are or become entitled. This is a very thorny question. In brief, in my opinion, the representative liability of trustees is nothing like so extensive as the Revenue suppose. See *Comments* C.5.

Beneficiaries are in general taxed only on income they receive. Yet there are important unresolved problems in the many cases where the statutory income of a trust is not equal to its real income. There are unimportant unresolved questions as to the source of income received by beneficiaries who are not entitled for an interest in possession.

2 Interest in Possession Trusts

Where a beneficiary is specifically entitled to trust income as it arises, then the income is the income of the beneficiary for income tax purposes and the source of his income is the underlying trust assets. The Revenue will contend that, at least where the income is taxable income, the trustees are always liable in a representative

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1 Reproduced from *Comments on the Inland Revenue Consultative Document on Trusts* written by the Consulting Editor and published for private circulation by Key Haven in 1991. [Updates have been added in square brackets.]

2 See *Kelly v Rogers* (1935) 19 TC 692 CA.

capacity to pay tax at the basic rate. This, however, is merely paid on account of the liability of the beneficiary. The beneficiary will be given a credit for it and, in appropriate circumstances, will be entitled to a repayment.

In the case of most trusts, the beneficiary entitled to an interest in possession will not be entitled to receive an amount equal to the taxable income of the trustees. One reason is that there will be expenses in administering the trust which are properly chargeable to income. This does not prevent the beneficiary being entitled to the gross income subject to a charge for the expenses, albeit that that amount might not be determined at the moment that the gross income arises.[3]

There are very important unresolved difficulties where, as often happens, the real income of the trust is not the same as its statutory income. This can arise in a wide variety of circumstances. I list simply some of them:

> The income may be taxable on the preceding year basis, so that the real income could be greater or lesser than the statutory income.[4]
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> Certain sums can be deductible in computing real income which are not deductible in computing statutory income. For example, in the case of a trading trust, entertainment expenses and depreciation.
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> Capital allowances may reduce the amount of taxable income, whereas balancing charges may increase the amount of this income.
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> The trustees may have losses brought forward from previous years to set against income of the current year.[5]

Nowhere in the statutes or in the authorities is there much guidance. One could make out a plausible case that where the statutory income exceeds the real income,

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3 *Baker v Archer-Shee* 11 TC 749 (HL).

4 The preceding year basis operates for Schedule D Cases I, II, III, IV, and V. Only Schedule A (income from UK land), Schedule C (income from government securities), Schedule E (emoluments of an office or employment which will be very rare in the case of trusts) and Schedule F (distributions from UK companies), are taxed on a current year basis. In practice therefore the preceding year basis is applicable to interest (except from government securities) and other annual payments, all income from abroad and business income. [1999 Note: with self-assessment, the preceding year basis has been abolished as regards investment income but still continues as regards trading and professional income.]

5 The position where what is income for tax purposes is capital for trust purposes does not in fact create a problem. Such income is clearly taxable as that of the trustees.

the tenant for life is to be taxable only on the real income and the trustees on the excess of the statutory income over the real income. Conversely, where the real income exceeds the statutory income, the tenant for life is taxable only on the statutory income and the trustees not at all. Hitherto, this has given the taxpayers the best of both worlds. The trustees will merely pay basic rate tax on the excess[6] whereas the beneficiary could pay a higher rate. Under the proposals in the Document, the trustees will be taxed at the highest rate even though this non-existent income cannot, ex hypothesi, be distributed. [1999 Note: these proposals were not implemented.]

There is a further complication. If there are trust expenses chargeable to income so that, if the statutory income equals the real income, the trustees would be taxable definitively on income used to defray such expenses, then, if the real income exceeds the statutory income and part of the real income is applied in defraying such expenses, it would be wrong for the tenant for life be taxable on the whole of the statutory income. But then does one tax the trustees upon the whole of the income used to defray expenses or does one, as it were, apportion the "exemption" resulting from the difference between the statutory income and the real income and, if so, on what basis ?

I do not even attempt to answer these questions in these Comments.[7] Suffice it to show, that there are very real problems at the heart of the taxation of even interest in possession trusts. These should have been fully explored in the Document and solutions proffered. The statement that the taxation of interest in possession trusts is satisfactory must necessarily depend upon ignorance of these difficulties.

3 Non-Interest in Possession Trusts

As soon as one passes to trusts which are not interest in possession trusts, then the difficulties increase geometrically - if, that is, the Revenue's view of the law is correct. At the heart of the difficulty is the nature of a discretionary payment of income received by the beneficiary. Suppose, for example, UK resident trustees invest in US securities. They receive interest which in the exercise of their discretion they pay out to a beneficiary who is not domiciled, resident or ordinarily resident in the United Kingdom. What is the proper tax treatment?

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6 By its nature, not being real income, it cannot fall with TA 1986 s.686(2)(a) as "income which is to be accumulated or which is payable at the discretion of ... any ... person".

7 Of course, I have my own views, but to set out and comment on all the options would be to write the Document for the Revenue.

To my mind, the matter is conclusively determined by two decisions of the House of Lords. Put them together and you have the result. It is as easy as "two plus two makes four". The first is *Drummond v Collins*[8] where payments were made out of a discretionary US trust for the benefit of infants resident in England.[9] In this case, of course, there was no question of the trustees being taxable in the first instance. The beneficiaries argued that what they received were voluntary payments and therefore they were not taxable. The House of Lords held that the payments were not voluntary but that the beneficiaries had a right to them. The way Lord Wrenbury put it is particularly revealing. The infants were contingently entitled to the income, that is, they were entitled to the income contingently on the trustees exercising their discretion. Once the discretion was exercised and the income of the trustees became the income of the beneficiaries, the beneficiaries were entitled, in the events which had happened, to what was clearly income for income tax purposes.

I find, if I may say so with respect, this analysis so simple, so glaringly obvious to any trust lawyer - so obviously right - quite apart from having all the authority of a decision of their Lordships' House, that I am amazed that it can have been so consistently ignored by the Revenue. *Drummond v Collins* is the classic case, one might almost say *the* case, on the taxation of beneficiaries under discretionary trusts. If one had time to read no other case on the topic, this should be the one. I recommend it to the authors of the Document.

In *Baker v Archer-Shee*,[10] the House of Lords decided that under a trust constituted under the law of England, a beneficiary entitled to an interest in possession was specifically entitled to trust income as it arose, subject of course, to the trustees' charge for trust expenses. The whole point of the decision was that the income to which the beneficiary became entitled was the income from the underlying trust assets and that the source of the beneficiary's income therefore was those assets. The claim that what the beneficiary had was merely a chose in action against the trustee, so that the source of the beneficiary's income was not the underlying trust assets but the trustees or the trust (or, to be more accurate, the chose in action against the trustees), was decisively rejected. Again, with respect, that decision was absolutely right. It simply established that income tax law follows private law in the realm of trusts.

Now put these two cases together. Where a discretionary beneficiary receives

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8 (1915) 6 TC 525.

9 As the income was remitted to the United Kingdom, the domicile of the infants was irrelevant.

10 11 TC 749.

income from the trust he receives it because he is entitled to that income. His hitherto contingent right has now become vested and indefeasible. When it comes to identifying the source of the income he has received, it cannot matter one iota whether he was absolutely entitled to the income as it arose or only became absolutely entitled to it at some subsequent date, namely when the trustees exercised their discretion. Once that has been done, he is in precisely the same position as a beneficiary entitled to an interest in possession. That is, what he has become entitled to is income from the underlying assets and the source of his income is those assets and not his chose in action against the trustees.

My conclusion, therefore, is that where trust income is distributed to a beneficiary in exercise of a discretion by the trustees (or, for that matter, by any other person), then the income to which that beneficiary becomes entitled is the same income as that which the trustees have received. Thus, in the example given, where a payment is made from income from US securities to a person not domiciled resident or ordinarily resident in the United Kingdom, that person is not taxable on the income because it is derived from a foreign source.

What, however, is the Revenue's view? Their view is that where a beneficiary receives a discretionary payment from a trust, then the source is the trustees. Or, to put it more accurately, I suppose, a right of action the beneficiary has against the trustees.[11] This is clearly erroneous.

It is, of course, true that once the trustees have exercised their discretion to make trust income the income of the beneficiary, he has the right to sue them for it. Yet it is equally true that a beneficiary entitled for an interest in possession has the right to sue the trustees for that income and it is plainly established that that does not alter the source of the income. Indeed, it would be ridiculous if it did.

Under what Schedule and Case does such income fall in the Revenue's view? It appears that they regard such payments as "annual payments" so that the trustees would, before 1973, have been able[12] to deduct basic rate tax on making the payment.[13] In the example given, the overseas beneficiary would have discovered

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11 I pass over the apparent obstacles to this analysis where the beneficiary never does become entitled to the income before it is paid to him or indeed to the cases where the income is never paid to the beneficiary at all but is applied by the trustees for his benefit and is thus deemed, on the basis of the other ratio in *Drummond v Collins*, to be the taxable income of the beneficiary.

12 Or, in certain circumstances, obliged.

13 Under TA 1970 s.52 or, exceptionally, s.53.

that because the trustees of the trust were UK resident he had been brought into the charge to UK tax on foreign income which had been distributed to him! One would have thought that such a ridiculous conclusion would have made the Revenue pause to consider the correctness of their views.

No doubt, in many cases the Revenue view does not lead to hardship. Until 1973/74 trustees could in general set the amount of any annual payments against their own tax liability, so at least double taxation was avoided in the simple case where the trustees and the beneficiary were domiciled and resident here and the source of income was in the UK. Since 1973/74, FA 1973 s.17[14] would in their view have operated instead of TA 1970 s.52 or s.53[15], but with broadly the same result. The covert proposal in Appendix A that Chapter I of the Settlement provisions[16] should apply to payments by trustees could wreak havoc with the system and produce totally unjustified double taxation.[17] All this, of course, is only on the basis that I am wrong and the Revenue are correct.

The difficulties which arise in relation to the difference between statutory and real income in the case of interest in possession trusts are intensified in the case of discretionary trusts, and intensified beyond measure if the Revenue's view is correct.

On my understanding of the law, by contrast, the difficulties are in principle no greater, and no less, than in the case of interest in possession trusts. One still needs to allocate the statutory income among the trustees and the recipient beneficiaries. There is one further slight complication, that income may be accumulated or otherwise be liable to the additional rate charge.[18] This is not an additional problem in principle - it simply means that the income must be apportioned over a greater number of categories.

There are also totally unresolved problems as to the extent to which the trustees are liable in a representative capacity in such a case. I can see that up to and until the moment where the income has become the income of the beneficiary, they should in principle still be liable to be assessed on it, whereas there is a good argument that

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14 Now TA 1988 s.687, which was clearly fashioned on the erroneous basis that the Revenue's view was correct.

15 Now TA 1988 s.348 and s.349(1).

16 TA 1988 Part XV.

17 See, A.75.

18 By being kept in suspense without being accumulated.

after that point they should not.

If the Revenue's view is correct, then they have the best of both worlds. Where the statutory income exceeds the real income they obtain tax on the statutory income, yet where the real income exceeds the statutory income, they obtain tax on the real income, provided it is all distributed.[19] If what the beneficiaries receive is income from a separate source, then it is immaterial whether or not it is paid out of real (trust) income which is also statutory (taxable) income, or out of income which is real income but not statutory income. In the latter case, the situation is just the same as if the discretionary payments of income had been made out of what was for both tax and trust purposes capital. In that case, they would indeed constitute annual payments. Thus, where, as is often the case, the trustees are under a duty to distribute all of their income in the exercise of their discretion, the benefit of all allowances and reliefs available to the trustees is entirely lost. Moreover, the preceding year basis works in a most unjust way: in effect, the Revenue obtain tax on the higher of the actual income of the current year or the actual income of the preceding year!

4 Taxes Act 1988 Sections 686 and 687

4.1 Section 686 - The Additional Rate Charge

TA 1988 s.686 and s.687[20] form a mini-code. They are thought of as dealing predominantly with discretionary and accumulation trusts.

Section 686 works tolerably well. It imposes an additional rate charge on trustees on real trust income which is retained within the trust. It therefore does not levy this charge on:

(1) trust income which is consumed in defraying trust expenses;[21]

(2) statutory income which is not real income;[22]

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19 Clever trustees who have a power to accumulate might be able to avoid some of the injustices by avoiding complete distribution.

20 Originally FA 1973 s.16 and s.17.

21 The precise scope of this exception is a matter of controversy. See *Comments* C.5.

22 Such income does not fall within TA 1988 s.686(2)(a) as it can neither be accumulated nor paid.

(3) taxable income represented by trust capital.

The proposal of the authors of the Document is to tax at a higher rate both (2) and (3) in future. That this is nowhere made express is one of their principal failings. It is disguised by the transition from a tax on income capable of accumulation or payment to a tax on income which is undistributed, whether or not it is capable of distribution.

Section 686 also currently charges at the additional rate income which must or may be distributed in the exercise of a discretion. If it is ultimately distributed as taxable income, the recipient will normally obtain a credit[23] for the tax paid by the trustees.

4.2 Section 687 Discretionary Annual Payments

The main comment about s.687 is that it hardly ever comes into operation at all. For it in terms applies only where a payment to a discretionary beneficiary would have constituted an annual payment and would have been liable to deduction of tax under TA 1988 s.348 or s.349(1). In my view, its only real scope is where a payment of income is made to a beneficiary out of trust capital.

5 Representative Liability of Trustees

The Revenue view is probably that trustees are in principle taxable upon all trust income and can be assessed on such income at the basic rate where tax has not already been deducted at source.

The position where trustees receive income which belongs to a beneficiary in equity as it arises is the most difficult. The statutes are relatively straightforward. If the trustee is trustee for a person under an incapacity or for a person who is not resident in the United Kingdom, then he is assessable on behalf of the beneficiary. In the former cases, he is assessable under TMA 1970 s.72, as is any guardian, tutor, curator or committee of an incapacitated person. In the latter case, he is assessable under TMA 1970 s.78, as is any guardian, tutor, curator, committee or branch or agent, or under s.79, as a branch or agent.[24] It has been judicially noticed that these provisions imply that there is no general representative liability on trustees,

23 As a matter of basic principle on my view; by virtue of s.687 in the Revenue's view.

24 One might well ask how a branch can be assessed, not being a legal person. The answer is probably that the phrase "branch of agency" is a composite expression and that only an agent who carries on a branch or agency can be assessed.

otherwise they would be unnecessary. See *Williams v Singer*[25] where the majority in the House of Lords clearly thought there was no general representative liability of trustees.

It is sometimes said that trustees are liable because they are persons "receiving or entitled to" profits.[26] My reading of *Williams v Singer* is that trustees are not "entitled" to income if there is a beneficiary who has a superior entitlement to the income. The whole basis of *Williams v Singer* was that the foreign income was not taxable because the person entitled to it was the beneficiary, who was neither UK domiciled nor resident, and not the trustees, who were both UK domiciled and resident.

I therefore conclude that the general representative liability of trustees is by no means established. In *Williams v Singer*, Viscount Cave, who spoke for the majority,[27] talked about the person having the "actual receipt and control" of the income. The trustees received the income. In my opinion, he intended to refer only to cases where the trustees were definitively chargeable. Where a beneficiary was absolutely entitled to income as it arose, the trustees might be in receipt of the income rather like a conduit but they could not be said to be in receipt and control of it because they did not have the right to retain it. The mere fact that there was a beneficiary with superior entitlement meant that they did not control it.

If my opinion is wrong and it is held that even in the absence of any express statutory provision, trustees are sometimes liable in a representative capacity and sometimes not, then one has to have a workable test to distinguish when they are and when they are not. Clearly, no-one could deny that *Williams v Singer* is authority for its ratio. It was, after all, a unanimous decision in the House of Lords which has not been affected by any subsequent statutory provisions. Even the Court of Session in *Reid's Trustees* had to agree that the trustees might, when being taxed in a representative capacity, have some defence to the assessment which was based on some exemption available to their beneficiary.

Williams v Singer was a clear case. Because the beneficiary entitled to the income was neither domiciled nor resident in the United Kingdom and the income did not have a UK source, then the income was, in a sense, not taxable income at all. But

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25 8 TC 387.

26 See TA 1988 s.21 (Schedule A) and s.59 (Schedule D). Tax under Schedules C, E and F is in effect usually deducted at source.

27 While their lordships dismissed the Revenue's appeal unanimously, they were not *ad idem* on all points.

what of other cases? Suppose that the beneficiary is entitled to some relief. It might be a personal allowance, or business expansion relief or excess capital allowances. It might be relief for trading losses. It might be a blanket exemption, such as that available to a charity or a pension fund. In which of these circumstances can the trustees set up the defence of the beneficiary? Is it desirable that trustees should have to enquire into the personal tax position of their beneficiaries, possibly the amount of their total income, in order to escape assessment? Is the only way the beneficiary can prevent this invasion of privacy to submit to the trustees being subjected to an entirely unwarranted charge to tax and leaving it to the beneficiary in due course to obtain a refund - a refund which will not be accompanied by proper commercial restitution for the free use the Revenue will have had of the money?

Another question is why, in the Revenue's view, is the trustees' liability limited to basic rate tax? Until 1973/74 that was because there was only one rate - the standard rate. I do not see what stops the trustees being liable for all rates.

None of the these vital questions is addressed in the Document.

6 Trust expenses

Income which is used by the trustees to defray trust expenses is chargeable at the basic rate. Why? The answer is very simple: that until 1973 such income was treated just the same as any other income and was therefore chargeable at the standard rate. The principle that there was no deduction for income so applied followed logically from the 1842 Act and was established in the late nineteenth century.[28]

In 1973 we changed from a standard rate of income tax with an earned income allowance to a basic rate of income tax with an investment income surcharge. Broadly speaking, the rate at which tax was paid remained the same, except for those in receipt of modest amounts of investment income and high amounts of earned income. It was decided that trustees who retained trust income should pay the equivalent of the investment income surcharge imposed on individuals. This was the "additional rate" introduced by FA 1973 s.16.[29]

The draftsman of FA 1973 no doubt thought, with some justification, that it would be rather harsh to levy the surcharge on income which the trustees had not

28 *Aikin v Macdonald* (1894) 3 TC 306.

29 Now TA 1988 s.686.

technically distributed but which was not being retained in the trust because it had been consumed. He therefore excluded such income from the additional rate charge.

The scope of the existing law is somewhat unclear. Income which is applied in defraying the expenses of the trustees in the year which are properly chargeable to income (or would be so chargeable but for any express provision of the trust) is clearly excluded, as it does not satisfy the condition in what is now TA 1988 s.686(2)(d). Yet there must be cases where (d) is redundant, as income which is applied in defraying any expenses of the trustees, whether chargeable to income not, would not in any case fall within (a). For if income is so applied it cannot be accumulated or paid at the discretion of any person. In *Carver v Duncan*,[30] the House of Lords did not decide this point: they merely interpreted (d) and laid down some very old-fashioned and highly unsatisfactory rules for determining when an expense is chargeable to income. Now if my view is correct, it might have cut the ground from under the Revenue's feet. I am told, by an informed source, that the view was taken that as the trustees had power when the income arose to distribute it, it was considered that it fell within (a). I would have thought that the contrary was not unarguable.

Now by 1973, statutory provision had long since been made whereby virtually all companies obtained a tax deduction for expenses of management. In the case of trading companies this had always been the case, whereas in the case of investment companies this is the subject of an express statutory provision.[31] My proposal is that we go back to first principles and ask why trustees should, unlike companies, pay tax on income used to defray expenses of management? These are, ex hypothesi, money down the drain, money spent for no other purpose than managing investments, money for which neither the trustees nor the beneficiaries have anything to show except income and gains which will be fully brought into charge to tax.

To my mind, there is not the slightest justification for treating trusts differently from companies. Trustees should therefore be able to deduct their expenses of management in computing their taxable income. Provisions should be introduced along the lines of those now applicable to investment companies.

It might be objected that individuals do not obtain tax relief for expenses of management. So, indeed, they do not. And that is a great injustice - an injustice which was perhaps the more pronounced when, in Socialist times, income was taxed

30 [1985] STC 356

31 TA 1970 s.304, now TA 1988 s.75.

at 98 per cent. One could very easily in those days finish up with a real loss. Ideally, such an exemption should be extended to individuals. I can see that that might meet with resistance from the Revenue. The principle is admitted in the case of companies: it should equally be admitted in the case of trusts. Trusts and companies have much more in common with each other than either of them have with individuals. In each case, there is an identifiable fund with persons whose duty it is to manage it, whether they be the directors of a company or the trustees of a trust. Often, they will be professionals and one of the most substantial items of management expenses will be the payment of professional fees.