The Personal Tax Planning Review

THE NEW INCOME TAX SETTLEMENT PROVISIONS

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Introduction

A Budget Press Release[2] promised that the income tax settlement rules would be replaced, with effect from 6th April 1995, with a shorter and "simpler" set of rules.

This is the latest change in an area of the law that has been developing for over 70 years. As soon as taxpayers began seriously to think of ways of avoiding tax they saw settlements as ideal vehicles, particularly for spreading income and capital amongst their families while, at the same time, retaining control or the ability to benefit from the income or capital; or, perhaps, the ability to unwind the settlement in the future. In the days of highly progressive tax rates the incentive to do this was very powerful.

Parliament took action very early to prevent the exploitation of settlements for the purposes of income tax avoidance. The first anti-avoidance legislation in this area was enacted in 1922 and, since that time, it has been considerably tightened up and extended as Parliament has fought to match the ingenuity of taxpayers. The result is that there was built up a complex set of measures, now contained in Part XV ICTA 1988, bringing within their boundaries arrangements which no-one unfamiliar with taxation would ever consider to be "settlements".

Although the various income tax settlement provisions are now collected together in Part XV, they have been introduced and amended piecemeal since 1922 and so

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2 IR21: 'Trusts and Settlements': Simplification of Income Tax 'Benefit to Settlor' Rules.

they do not represent such a unified whole as might be expected. The position was summed up by Walton J who said:

> "The difficulty, of course, in discerning any consistent pattern in the various Chapters of Part XVI of the 1970 Act is that they all spring from totally different origins, and thus do not in any sense represent what would obviously be highly desirable, namely a 'code', in any shape or form."[3]

Furthermore, as most of these provisions were first drafted decades ago, the draftsmen did not have in mind the complex and sophisticated arrangements used in modern tax planning. This legislation can therefore operate in a clumsy and unintended way.

There have been calls for many years for this legislation to be codified and simplified. At last it seemed that this was to be done, and we waited with anticipation for the Finance Bill 1995 to be published. The Bill contained measures that would have meant that no fewer than 25 sections of ICTA, 1988 would have been repealed and replaced with a new code involving three main charging provisions, two of which were simplified versions of charges under the old rules. The third charge was intended to replace one of the most unsatisfactory pieces of legislation on the statute books; a provision that has come in for unusually severe criticism from the courts. Unfortunately, this new charging provision was so ill thought-out that it has had to be abandoned as a result of mounting objections from the legal and accountancy professions and elsewhere.

Whereas the Budget Press Release stated that the new regime was not primarily designed to alter the extent or the amount of the tax charge, and that the Exchequer effect was expected to be "negligible", this turned out not to be the effect of the new loan provisions. As a result of the abandonment of the proposed loan provisions and the reintroduction of the old rules, the one part of the income tax settlement code that most needed replacing is still with us. Given that the rules have needed overhauling for so long, it is unacceptable that the Finance Bill provisions were so ham-fisted.

This article analyses the new rules in the Finance Bill (as amended in Committee) and discusses the extent to which they are an improvement on those they replace.

The New Rules

Sections 660 to 685 ICTA 1988 have been repealed with effect from 6th April 1995, except that, because of the U-turn on the provisions relating to loans to and

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3 *Ang v Parrish* [1980] STC 341 at 345.

from settlements, sections 677, 678 and certain supplementary provisions have been reinstated, and the new proposed sections 660C and 660D, which were to have been inserted, have been abandoned.

Unlike the old rules, there is a single definition of "settlement" and "settlor".[4] The definition of "settlement" is the same as one in the old section 670. In other words, it "includes any disposition, trust, covenant, agreement, arrangement or transfer of assets". The term "settlor" is defined in almost identical terms to the definition in section 681(4). Thus, a settlor is any person by whom the settlement was made. A person is deemed to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular, if he has provided or undertaken to provide funds directly or indirectly for the purposes of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement.

As regards the commencement of the new rules, it should be noted that they apply from 6th April 1995 to all settlements whenever and wherever made.[5]

As a result of the introduction of the new sections, and the reinstatement of the rules relating to capital sums paid to the settlor in sections 677 and 678, we are left with three main charging provisions, two arising out of the Finance Bill changes (although replacing parallel rules in the old provisions), and one of the old charges. The three charges are:

(1) settlements where the settlor retains an interest;

(2) payments to unmarried minor children of the settlor; and

(3) capital sums paid to the settlor.

Each of these will be considered in turn. The aborted provisions relating to loans to and from settlements will also be mentioned briefly to consider what was wrong with them and the reason why they had to be scrapped.

Settlements Where the Settlor Retains an Interest

This provision is contained in section 660A. This section relates to income arising under a settlement from property in which the settlor retains an interest. Such income arising during the settlor's life is treated, for all tax purposes, as the

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4 ICTA 1988 s.660I(1) and (2).

5 FB 1995 cl.68(2), as inserted at Committee Stage.

settlor's income and not as the income of any other person. This does not apply to property in which the settlor has no interest.[6]

The meaning of the phrase "income arising under a settlement" is the same as in section 681(1), but with an additional proviso. It is defined as including any income chargeable to income tax by deduction or otherwise, and any income which would have been so chargeable if it had been received in the United Kingdom by a person domiciled, resident and ordinarily resident there. However, where the settlor is not domiciled, not resident, or not ordinarily resident in the United Kingdom, the term does not include income which would not have been subject to tax in the relevant year of assessment if the settlor were actually entitled to it. But if such income is later remitted to the United Kingdom in a year of assessment in which the settlor is resident in the United Kingdom, it is treated as arising in that year for the purposes of the new settlement provisions.[7] The new rules are therefore less favourable to non-domiciled settlors than the old ones. Income arising outside the United Kingdom and accumulated can now become subject to United Kingdom tax if it is later remitted to this country.

This section uses the concept of "derived property" which is taken from the old section 685(3), namely, income from the property in question, or any other property directly or indirectly representing proceeds of, or of income from, that property or any income from it.[8]

The circumstances in which a settlor will be deemed to have retained an interest are narrower than under the old rules. A settlor has an interest in property if it, or derived property, is or will or may become payable to, or applicable for the benefit of, the settlor or the settlor's spouse.[9] A spouse for these purposes does not include a future spouse,[10] a widow or widower,[11] or a spouse from whom the settlor is separated under a court order, a separation agreement, or in circumstances such that the separation is likely to be permanent.[12] Furthermore, income is not within this section if it arises under a settlement made by one party

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6 ICTA 1988 s.660A(1).

7 s.660I(3) and (4) ibid.

8 s.660A(10) ibid.

9 s.660A(2) ibid.

10 For the previous position see *IRC v Tennant* (1942) 24 TC 215, and Inland Revenue Statement of Practice SP/A30.

11 This gives statutory effect to the decision in *Vestey's Executors v IRC* (1949) 31 TC 1.

12 ICTA 1988 s.660A(3).

to a marriage to provide for the other, and it is income payable to or applicable for the benefit of the other party, after the dissolution or annulment of the marriage, or while the spouses are separated under a court order, a separation agreement, or in circumstances such that the separation is likely to be permanent.[13]

A settlor is not regarded as having an interest in property:

(1) if and so long as none of it, and no derived property, can become payable to, or applicable for the benefit of, the settlor or the settlor's spouse except in the following circumstances:

  (i) the bankruptcy of a person who is or may become a beneficiary entitled to the property or any derived property;

  (ii) an assignment of or charge on the property or any derived property being made or given by such a person;

  (iii) in the case of a marriage settlement, the death of both parties to a marriage and of all of the children of the marriage; or

  (iv) the death of a child of the settlor who had become beneficially entitled to the property or any derived property at an age not exceeding 25; or

(2) if and so long as some person is alive and under 25 during whose life the property, and any derived property, cannot become payable to or applicable for the benefit of the settlor or the settlor's spouse except on that person becoming bankrupt or assigning or charging his interest in the property, or in the derived property.[14]

From the above it can be seen that the circumstances in which a settlor can be treated as retaining an interest are in two respects narrower than under the old rules (see section 673 and section 685). The first is that the definition of spouse is restricted. Secondly, the exclusions in (1) and (2) above are wider than those that used to apply under the old rules. As regards (1), circumstances (i) to (iii) are the same or similar to those applying under the old regime, but (iv) is a wider exclusion than the one that previously applied. Section 685(2)(d) referred to "the

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13 s.660A(8) ibid.

14 s.660A(4) and (5) ibid.

death under the age of 25 or some lower age of some person who would be beneficially entitled to the property or the derived property on attaining that age".[15] It can be seen that (iv) now refers to the death of a child of the settlor who had become beneficially entitled to the property or to derived property at an age not exceeding 25. So long as the child became beneficially entitled on or before 25 his or her death can now occur after that age. This analysis assumes that the words "at an age not exceeding 25" refer to the child becoming beneficially entitled rather than the death of the child. This is presumably what the draftsman intended, but the paragraph could have been more clearly worded.

As regards (2) above, this is a reenactment of section 673(3)(b), which did not apply to sections 674A or 683. This exclusion has been made generally applicable to section 660A situations, and so is of much wider significance.

A settlement for the purposes of this charge does not include an irrevocable allocation of pension rights between spouses under a statutory scheme within Chapter I Part XIV ICTA 1988.[16] Neither does it include an outright gift from one spouse to the other, unless the gift does not carry a right to the whole of the income arising from it, or unless the property given is itself wholly or substantially a right to income. A gift is not an outright gift if it is subject to conditions, or if the property (or derived property) can be payable to or applicable for the benefit of the donor.[17] This is a reenactment of section 685(4A) to (4C).

The charge does not apply to income consisting of annual payments made by an individual for bona fide commercial reasons in connection with his trade, profession or vocation; or where it consists of covenanted payments to charity within section 347A(7).[18]

This new charge will affect annual payments made under existing obligations as defined in section 36(4) Finance Act 1988, such as non-charitable covenants made before 15th March 1988. With effect from 5th April 1995, such payments will be treated as the income of the settlor for all tax purposes, and not merely for the purposes of higher rate income tax. Accordingly, the settlor will not get basic rate tax relief on them, and they will not be treated as the income of the recipient for the purposes of basic rate tax. Consequently, recipients who do not pay tax, or who pay tax at only the lower rate, will not be able to claim repayment of any tax deducted by the payer.

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15 s.673(3)(c)(iv) ibid had similar wording.

16 s.660A(7) ibid.

17 s.660A(6) ibid.

18 s.660A(8) ibid.

Payments to Unmarried Minor Children of the Settlor

The second charge is contained in section 660B. This is based on the old sections 663 and 664. It applies to settlement income which is not taxed in the settlor's hands under section 660A, but which is, during the settlor's life, paid[19] to, or applied for the benefit of an unmarried minor[20] child[21] of the settlor. Such income is treated, for tax purposes, as the income of the settlor, for the year in which it is paid, and not as the income of any other person.[22] However, total income payments to a child of £100 or less per year of assessment do not give rise to a charge on the settlor.[23]

A payment out of retained or accumulated income to or for the benefit of an unmarried minor child of the settlor is also deemed to be the income of the settlor to the extent that there is "available retained or accumulated income". This applies whether the payment is made under the terms of the settlement, or by virtue of statute, such as section 31 Trustee Act 1925.[24]

For these purposes, available retained or accumulated income is the total income of the settlement from the date it was established, less:

(a) income that has been treated as the income of the settlor or a beneficiary;

(b) amounts of income or capital that have been paid to beneficiaries other than unmarried minor children of the settlor; and

(c) amounts paid out in defraying expenses of the trustees, where such expenses were properly chargeable to income (or would have been but for an express provision of the trust).[25]

There is a provision in similar terms to that previously contained in section 663(2) to the effect that, if an offshore income gain within the meaning of Chapter V Part

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19 In money or money's worth: s.660B(6)(c) ibid.

20 Namely, under 18 years of age: s.660B(6)(b) ibid.

21 Including a stepchild and an illegitimate child: s.660B(6)(a) ibid.

22 s.660B(1) ibid.

23 s.660B(5) ibid.

24 s.660B(2) ibid.

25 s.660B(3) ibid.

XVII accrues in respect of a disposal of assets by a trustee holding them for someone who would be absolutely entitled to them but for being a minor, the income treated as arising by virtue of section 761(1) is deemed to have been paid to that person. Where that person is a child of the settlor, that income is treated as the settlor's.[26]

Loans Between Settlor and Trustees

These charging provisions were to have been contained in sections 660C and 660D. The charge was to have been made by reference to notional interest at the official rate[27] on loans[28] outstanding between the settlor and the trustees.

Briefly, the details were as follows. Where, during the life of the settlor, there is outstanding a loan between the settlor and the trustees (whether the creditor is the settlor or the trustees), and the interest (if any) is less than the official rate, there was, under section 660C, to be treated as income of the settlor interest at the official rate less the amount of any interest actually paid.

Under section 660D, there was to be deemed to be an outstanding loan for the purposes of section 660C if there was a loan from the trustees to a company connected with the settlement which was matched by a loan from the company to the settlor. Similarly, there was to be an outstanding loan for those purposes if there was a loan from the settlor to a company connected with the settlement which was matched by a loan from the company to the trustees.

The matching of the loans was to be done on a three year rolling basis whereby, for each year of assessment , the current year and the two previous years were to be relevant to the computation. For each year of assessment, each loan was to be taken separately, and the amount that would have been treated as the income of the settlor under section 660C, if the loan had been between the settlor and the trustees, was to be found. This amount was to be referred to as the "notional income".

Take the example of a loan by trustees to a connected company (Loan 1), which company in turn makes a loan to the settlor (Loan 2). One assumes that both Loan 1 and Loan 2 are between the settlor and trustees, and the notional income for each loan is effectively interest at the official rate less any actual interest, using the section 660C rules set out above.

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26 s.660B(4) ibid.

27 Namely, the rate applicable under FA 1989 s.178: ICTA 1988 s.660C(4)(b).

28 For this purpose, "loan" meant any kind of credit made available directly or indirectly by the trustees for the benefit of the settlor, or vice versa: s.660C(4)(a) ibid.

The second stage is to set off, for the company (or for each connected company, if there is more than one), the notional income on any loan from the company to the settlor against the notional income on any loan from the trustees to the company. The same procedure was to be used if the loans were going the other way, namely, from the settlor to the company, and from the company to the trustees.

In making this set-off, one takes, in relation to each loan, the notional income in the current year of assessment plus the notional income in the two previous years to the extent that it has not already been matched. The notional income matched in this way was the amount of the income treated as the income of the settlor for the current year of assessment.

Problems with the Proposed Loan Provisions

The result of fixing the tax charge by reference to the official rate of interest on loans outstanding between the settlor and the trustees was that the tax charge would not have related in any way to the income (if any) of the settlement. This contrasted with the position under the old section, which has been reinstated, under which it is the undistributed income of the settlement that can be attributed to the settlor.

The provisions contained in sections 660C and 660D would not have produced the result promised by the Budget Press Release, namely, that the new rules will not alter the extent or the amount of the tax charge.

The proposed rules would have had some unexpected consequences, particularly in relation to charities and certain bonds that are in wide circulation for the purposes of inheritance tax planning. Indeed, before it was announced that the whole loan regime was to be abandoned, a much smaller amendment was planned whereby charities were to be excluded from the new regime. However, the inequitable consequences would not have stopped at inheritance bonds and charities; there would have been other problems. Some of the potential problems are discussed below.

One of the biggest problems would have been in relation to charities. Many interest-free loans are made to charitable trusts. Under section 660C, if an individual made a gift to a charitable trust, and later made an interest-free loan to that charity, the individual would have been subject to tax by reference to the official rate of interest on that loan. This was because, when the individual made the gift to the charitable trust, he would have become a settlor in relation to the trust.

Another problem was that, as noted above, certain arrangements marketed for estate planning purposes would have been hit by the new rules. Under these schemes an individual would take out a single premium insurance bond held under trust for his chosen beneficiaries. Further funds would then be provided to the trustees by way of interest free loan from the individual. These further funds would be used by the trustees to take out another single premium bond on the settlor's life. Annual payments of "income" would be made to the individual by the partial encashment of the bond by the trustees. These popular gift and loan schemes would have generated a income tax charge in the hands of the settlor based on the application of the official rate to the outstanding loan. What is more, there would have been no credit for the income tax and capital gains tax generated during the life of the bond, or on its surrender.

This produced a wave of criticism from the Association of British Insurers and others. Many thousands of individuals who had become involved in such schemes before the Budget would have found themselves penalised.

At first, the Inland Revenue did not appear to be concerned about the fact that these inheritance tax bonds would have been caught in this way. This was because they were being used for what was seen as tax avoidance. However, the Inland Revenue appear to have been taken aback by the volume and vehemence of the objections.

In any case, it was not only loans to charities and inheritance tax bonds that would have been hit by the new rules. Family trusts would also have been affected. For instance, a loan to a trust to enable the trustees to acquire a property for a beneficiary, such as a child of the settlor, would have given rise to an income tax charge based on the official rate of interest even if the settlement had received no income.

It was situations such as this, in which, contrary to what was said in the Budget Press Release, the extent and amount of the tax charge would have changed, that caused widespread protest that caused the Government to climb down.

It is therefore necessary to consider the provisions that have been reinstated. It will be seen that they are just as undesirable in their own way as the abandoned loan provisions.

The Reinstated Provisions

The sections that were reprieved were sections 677, 678, and supplementary provisions. Section 677 was introduced in 1938. Although it was amended and supplemented, particularly to fill a gap exposed by *Potts' Executors v IRC*[29], it has remained largely unaltered since 1938. This is surprising considering that it is

[29] (1951) 32 TC 211.

a badly drafted provision that has come in for some particularly scathing criticism from the courts. For example, in the *Potts' Executors* case, Lord MacDermott said that the section seemed "capable of involving straightforward transactions to such a considerable extent that a decision [of the courts] which may encourage the substitution of something better need not be a matter for regret".[30] The section has also been called "monstrous" and "wholly unjust", and reference has also been made by judges to the "absurd results" and the "grave defects" of the section. Perhaps the damning comment came from Lord Reid in *IRC v Bates* who said:

> "This case may well afford ammunition to the body of opinion which holds that redrafting of the Income Tax Act ought to be taken out of the hands of those at present responsible".[31]

These criticisms are amply shown to be justified by the fact that, of the first four cases decided under these provisions, in one, *Potts' Executors v IRC*[32], a tax avoider escaped liability; and in each of the other three, *IRC v De Vigier*[33], *IRC v Bates*[34], and *McCrone v IRC*[35] a completely innocent taxpayer was caught by the section.

Yet despite the unsatisfactory state of the section, the Inland Revenue and Parliament remained for a long time totally insensitive to the appalling state of the provisions (except where it operated to the detriment of the Inland Revenue in the *Potts' Executors* case when the law was changed immediately). As a result, this section has remained on the statute books for almost 60 years as a trap for the innocent taxpayer and, in some cases, as minor inconvenience for the well-advised tax avoider.

In the circumstances, it is a poor reflection on the competence of those involved in the preparation of the new regime that this section has had to be reintroduced. The plain fact is that this section was the one most in need of being replaced.

It is not necessary to analyse sections 677 and 678 in detail here. They have been around for so long that their defects are well known. Briefly, the effect of section 677 is that, where capital sums are paid by the trustees directly or indirectly to the

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30 p 236.

31 (1966) 44 TC 255 at 263.

32 (1951) 32 TC 211.

33 (1964) 42 TC 25.

34 (1966) 44 TC 255.

35 (1967) 44 TC 142.

settlor in a particular year of assessment, to the extent to which such of those capital payments fall within the "income available", that income is to be regarded as the income of the settlor.[36] The term "capital sum" is defined widely as any sum paid by way of loan or repayment of loan, and any other sum not paid as income otherwise than for full consideration (subject to certain limited exceptions not considered further here).[37] One of the many problems arising out of the way this provision has been drafted is that, whereas normal capital sums to the settlor are only caught if they are paid otherwise than for full consideration, loans are not subject to the same restriction: they are within the definition even if they are on an arm's length basis. Loans made by or to the settlor are therefore a constant trap waiting to catch innocent taxpayers. It can be seen from the description of the abandoned loan provisions set out above that they tried to tackle this particular problem by linking the tax charge to interest at the official rate. Unfortunately, the new provisions suffered from other defects, as has been explained.

Perhaps a more fundamental problem with section 677 arises out of the computational difficulties to which the section gives rise. For a description of these problems, see the judgment of Lord Reid in *IRC v Bates*[38]. Some, but by no means all, of the difficulties were addressed by section 42 Finance Act 1981. Section 42 also introduced what is now section 678, relating to capital sums paid by a body corporate connected with a settlement. This section is not considered further here.

Given the unsatisfactory nature of sections 677 and 678, it is most unfortunate that they have had to be reintroduced, even if their reprieve is (it is to be hoped) only temporary.

Conclusion

On the whole, sections 660A and 660B represent a reasonable attempt to codify and simplify the old legislation. Practitioners should find it much easier to find their way around the new provisions when compared to the sections that have been repealed. Sadly, the same cannot be said for the loan provisions which were to have been contained in sections 660C and 660D. These sections were ill-thought out and fundamentally flawed. Given that Parliament had the laudable aim of replacing legislation that has come in for some severe judicial criticism, it is a pity that there was not a fuller consultation process. The publication of draft clauses a few months before the Finance Bill was prepared, giving interested parties the

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36 s.677(1) ibid.

37 s.677(9)(a) ibid.

38 (1966) 44 TC 225 at 261-262.

opportunity to comment and to make representations, would have avoided the shambles into which this important legislative exercise has descended.