The Personal Tax Planning Review

PITY THE DRAFTSMAN?

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Introduction

In a previous issue of *The Personal Tax Planning Review*,[2] Robert Grierson thoroughly analysed s.664(2)(b) and (3) of TA 1988. Broadly, these provisions ensure that capitalised accumulated income which is subsequently paid out of a settlement to or for the benefit of an unmarried minor child of the settlor will still be treated as the parent's income. However, as he showed, where the payment exceeds accumulated income, further income accumulations thereafter which reinstate the original capital fund will not be deemed to be income if they are subsequently paid out. Thus, where the original capital has been depleted by such payments, later income accumulations are protected from the deeming process to the extent of that depletion. As this simple concept has been wrapped up in a complex and convoluted statutory formula, it took Mr Grierson almost 13 pages to unravel it and, not surprisingly, at the end of his Herculean task he called for any fresh legislation to be more lucid. Although much of the responsibility for poor drafting must lie with Parliamentary Counsel, the writer's examination of the relevant historical documents left an abiding sympathy for his unenviable position. He is buffeted by overriding political considerations, demanding Inland Revenue instructions and inflexible deadlines.

This article uses primary sources to trace the historical background to the children's settlement legislation introduced in 1936 with particular reference to the provisions analysed by Mr Grierson. Its main purpose is to show that these provisions failed to achieve their intent but it also gives a flavour of the difficulties which the draftsman faced and spotlights the real culprits.

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Getting the Go-Ahead

Before any drafting of tax legislation takes place, the Revenue normally obtain the Chancellor's agreement. In the case of children's settlements, although the Revenue had considerable evidence of the tax planning methods being used, their rapid growth, and the large amounts of tax involved, they took no action until the number of children's repayment claims was more than doubling each year. In November 1935, the Chairman of the Board wrote to the Chancellor "to press ... the urgency of taking some step to check the evil".[3] The Chancellor merely passed on the paper to the Treasury, which, seeing a growing loss of money, was very much in favour of legislation. However, political considerations made the Treasury suggest to the Chancellor that .."the sting could be taken out of the proposal if ... a relief equal in amount to the present loss [of tax is given] to taxpayers with young children".[4] This set the stage for a series of damaging delays which began with the Chancellor passing the matter to the Financial Secretary for further investigation.

The Financial Secretary's investigation took almost six weeks to conclude and it involved the study of a series of papers prepared by the Revenue and a considerable number of meetings with them. Eventually, he advised the Chancellor to go ahead but suggested buying an escape route from any political difficulties by increasing child allowance by £10. Having persuaded the Financial Secretary that irrevocable capital settlements should be caught by their proposals, the Revenue found out later that the Chancellor was not yet convinced. This, and the considerable delays in getting the go-ahead, put an enormous strain on the Revenue and Parliamentary Counsel in drafting appropriate legislation.

Initial Drafting

It was early in March 1936 before the Financial Secretary instructed the Revenue to draft a clause and, as the Chancellor was undecided on the details, it was to be drafted "on wide lines".[5] The covering note to the Revenue's draft clause sent to Parliamentary Counsel explained that the legislation was to catch dispositions of income, outright capital transfers and income accumulated for the child's benefit. Having tidied up the Revenue's first effort, the draftsman raised a few technical points with them and even asked how the clause would apply to a case in which he was a trustee. Although it is surprising to see the draftsman asking such a

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3 Public Records Office, (PRO) file IR63/101 p 24.

4 Ibid p 46.

5 Ibid p 181.

question, it emphasises his uncertainty about how the provisions would operate in practice and the Revenue's influence over the details.

After much to-ing and fro-ing, a copy of the draft clause was sent to the Financial Secretary in the middle of March 1936. It deemed all income of a minor unmarried child derived from its parent, whether by outright gift of capital or otherwise, to be the parent's. This was achieved by what is now s.663(1) and s.664(1) TA 1988. Under the Revenue's plans there were to be no other substantive provisions. However, two weeks later, the Financial Secretary questioned their proposal for irrevocable settlements of capital to be caught. He also foresaw trouble in getting Parliament to agree provisions deeming accumulated income as the parent's.[6] The Revenue came back within 24 hours with a forceful seven page paper arguing that it was essential that such settlements and accumulated income be caught.[7] The response was delayed until after the Chancellor's budget statement and, as a result, Parliamentary Counsel had to prepare a draft resolution for the Ways and Means Committee which was so non-committal that he believed it would cause considerable alarm. The Chancellor's indecision was beginning to cause severe problems.

A Change of Direction

The Chancellor's budget statement described the children's settlement provisions as making "certain minor changes in the legislation"[8] even though they would apply to income which was "in any way derived from the parent"[9]. This drew considerable fire from the Chancellor's own backbenchers and strong pleas for special treatment of irrevocable trusts.[10]

Even by early May the Chancellor was still undecided about the scope of the provisions and asked the Chairman of the Board of Inland Revenue for the implications of three alternative courses of action.[11] The Revenue quickly produced a report but the Chancellor was still not satisfied and requested their views on a possible five year exemption for existing irrevocable settlements. The

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6 Ibid p 188.

7 Ibid p 188-194.

8 Hansard, 21st April 1936, Col 45, Mr Chamberlain.

9 Ibid Col 48.

10 For example, see Hansard, 22nd April 1936, Col 229, Major Hills.

11 PRO file IR 63/141 p 199.

Revenue responded almost immediately and by the afternoon of 5th May they were able to advise the draftsman that it had been decided to exclude accumulated income but to charge income paid to or for the benefit of the child. However, they had already foreseen anomalies in drawing a distinction between income payments and capital payments and drew these to the draftsman's attention.

> "The difficulties would be in drawing the distinction between spent income and accumulated income ... In order that the charge may be effective, we feel that we must have a provision to the effect that any payment made by the trustees ... shall be regarded as income insofar as the trustees have received income from the beginning of the settlement sufficient to cover the payment made. Otherwise, it might be represented that under the settlement the trustees were at liberty to devote the capital as well as the income and that a particular payment was in fact an appropriation of capital and not of income"[12].

It should be noted that the clear intention was that a capital payment was to be deemed to be income if it could be linked with a prior accumulation of income. However, a rather different result was actually achieved, as Mr Grierson pointed out in his article.

The Re-drafting

Parliamentary Counsel had at last got final instructions and within 24 hours was reluctantly sending the Revenue his redraft "which I am quite sure is nowhere near right"[13]. In a flurry of activity in the few days before publication of the Finance Bill, three further redrafts were made. Normally there is an exchange of memoranda for each draft as suggested changes are explained and discussed, but in this case, probably because of the great urgency, there is nothing on the files.

With only minor differences, s.664(2)(b) and (3) TA 1988 were originally in clause 19(3)(b) of the Finance Bill 1936. The clause deemed a capital sum to be income "unless and except to the extent that the sum so paid together with any other sums previously so paid (whether to that child or to any other child who, at the commencement of the year of assessment in which that other sum was so paid, was an infant and unmarried) exceeds the aggregate amount of the income which has arisen under the settlement since it took effect". The notes on clauses provided by the Board of Inland Revenue to Ministers explain the purpose of the above provision as follows:

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12 Parliamentary Counsel, Finance Bill 1936 file, pp 3683-3685.

13 Ibid Letter 6th May 1936.

> "... As income which is spent on maintenance of the child is being charged as the parent's ... and income which is accumulated is not being so charged, it would be easy, without some safeguard, to arrange that the capital of the settlement be expended on the child and that all the income should be accumulated. [This] provides the necessary safeguard and enacts that all sums paid under such a settlement for the benefit of a minor child shall be deemed to be payments of income ... to the extent that there is income of the settlement available to cover the payment"[14].

Again, the intention to treat a capital sum as income to the extent it could have been paid out of accumulated income is clear.

Statements of Intention

At the Committee Stage, the only amendment of substance to clause 19(3) ensured that where a revocable settlement was made irrevocable, the exclusion from charge on undistributed accumulated income only applied from the date of change. The notes for Ministers on this amendment reconfirm that "all sums paid under such a settlement for the benefit of a minor child are to be deemed to be payments of income ... to the extent that there is income of the settlement available to cover the payment"[15].

A proposed amendment attempted to limit the clause to payments "out of income so dealt with (i.e., accumulated) or assets representing it". The Revenue's advice to Ministers to reject this limitation gives a very clear indication of the intention of the provisions.

> "...It is necessary to provide for the possibility that the income accumulated and, therefore, excluded from charge in any one year, may actually be spent upon the child in some later year. It is necessary, moreover, to cover the case where the spending in the later year might purport to be in the form of capital and not in the form of income. [It is provided] that any payment of any kind made in such a case shall be deemed to be income insofar as there is in the hands of the trustees income, or assets representing such income, which has been excluded from charge in the past by reason of its accumulation ... The trustees might represent the sum paid as having been paid not out of the income, or assets representing it, but out of the original capital transferred to them, and thus the amendment ... proposed would defeat the reasonable purposes of the

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[14] PRO file T171/325.

[15] Parliamentary Counsel, Finance Bill 1936 file, p 1336.

> paragraph. It is reasonable that if any income accumulated in the past has been excluded from charge, any payment made should be regarded as coming out of that untaxed accumulated income insofar as it is sufficient to cover the payment."[16]

The same point was made by the Financial Secretary during the debates on the proposed amendment.

> " ...Any payment of any kind should be deemed to be income, insofar as it is in the hands of the trustees income which has been excluded from the child, for the reason that it was believed to be accumulating in the fund."[17]

A Fatal Amendment

Towards the end of May, the draftsman discovered a technical defect in the provisions and suggested a corrective amendment at the Report Stage "instead of muddling it up in the Committee with the other point as to the variation of the settlement"[18]. The flaw was that accumulated income, which might be treated as the settlor's, would include income accumulated for, or subsequently paid out to, persons other than the children of the settlor. As this was too harsh, an amendment was made by inserting "by virtue or in consequence of the settlement has been paid to or for the benefit of the child of the settlor or dealt with as mentioned in sub-section (2) of this section" - the same words as now appear in s.664(3) TA 1988.

The purpose of the change was explained by the Chancellor in the following terms:

> " ...The settlement might cover other beneficiaries besides the children of the settlor, and in that case the words ... 'income which has arisen under the settlement', will include not only the income which had been paid to or been accumulated for the benefit of the children, but also the income which had been paid to or accumulated for the benefit of other persons. What we want to compare is the total sum paid for the benefit of the child of the settlor, on the one hand, and, on the other hand, the actual amount

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16 Ibid p 1339.

17 Hansard, 15th June 1936, Col 755, Mr W S Morrison.

18 Parliamentary Counsel, Finance Bill 1936 file, p 3733.

> of the income under the settlement paid to or accumulated for the benefit of the children."[19]

Clearly, the intention was still to deem capital payments to be income to the extent of relevant accumulated income; an intention which had not changed right from the start. However, the Report Stage amendment was the fatal one which made the provisions miss their mark. As there is no ambiguity in the legislation, what was said in Parliament is irrelevant and the provisions work rather more advantageously than was intended. For example, if £100,000 is settled and £40,000 of it is distributed in year 1, subsequent accumulations of income can be paid out later to the settlor's children without being deemed the settlor's to the extent that the prior accumulations merely reinstated the original settlement capital. Thus the intention to catch such accumulations was not achieved.

Who was to Blame?

Given this series of events, the blame for the complexity of these provisions and the fact that they missed their mark does not lie entirely with the Revenue or the draftsman. The Revenue put the problem to the Chancellor in good time but simply could not get him to make up his mind until the eleventh hour. As a result, the draftsman had to hurriedly rewrite virtually the whole of the children's settlement provisions. Perhaps he should have been able to get the drafting on the accumulations point absolutely right, but he had no precedent to work with. The records also show that his attention was drawn elsewhere, for instance, in ensuring that the definition of irrevocability was watertight. Furthermore, he was distracted by Machiavellian ploys such as the decision to hold back the intended *de minimis* exemption for income under £5 and present it later as a concession so that the Government would appear to be open to reasonable suggestions. When required to produce the appropriate letout for the Report Stage, he had great difficulty in doing so, as the following extract shows.

> "... I have been completely defeated by your proposal ... There must be some way of giving [it] effect without enabling a settlor to evade the clause by making a large number of £5 settlements, but I have not succeeded in finding it. As a matter of drafting this is extraordinarily difficult."[20]

A further difficulty the draftsman faced was that the children's settlement provisions were more complex than almost any other tax provisions prior to 1936. Although this complexity gave the Chancellor problems in Parliament, he

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19 Hansard, 1st July 1936, Col 445, Mr Chamberlain.

20 Parliamentary Counsel, Finance Bill 1936 file, p 3815.

contended that the variety of forms of avoidance and the necessity for watertight provisions made plain simple language impossible. He invited critics to try using simpler language but warned that his own frequent experiments to do so had always shown that there was a good reason for every word.[21] Despite his efforts, the Chancellor was unable to quell the parliamentary grumbling, as the following typical comments show.

> "There are many who, like me, do not know exactly what we are doing or what the effect of this clause is."[22]
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> " ...The real proof of the unintelligibility of the clause was ... [that] every speech was read ... because neither Ministers nor members could make speeches on this subject without lavishly prepared briefs."[23]
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> "It is the most complicated clause that I have ever had to deal with. I have had to deal with settlements ... for 45 years, and I have taken this clause home and tried to read it and understand it but I have entirely failed. I sent it to the very best counsel at the bar and I have received several letters from them to say that it is totally unintelligible. There has been a Committee of the Law Society studying it [but] ... they are thoroughly puzzled by it."[24]

Not only was the draftsman struggling with these complex provisions, he was also grappling with an extraordinarily complex Bill by the standards of the day. It included anti-avoidance provisions governing transfers of assets abroad and blocked further loopholes discovered in the close company rules. All these anti-avoidance provisions were dealt with together for political reasons as the Chancellor wanted to "get the matter over, rather than have a series of difficult debates in successive years"[25]. Political expediency was therefore as much to blame for the legislative error as any failings of the draftsman or the Revenue.

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21 Hansard, 20th May 1936, Col 1266, Mr Chamberlain.

22 Hansard, 15th June 1936, Col 841, Mr Albery.

23 Ibid Col 842, Mr H G Williams.

24 Ibid Col 847, Sir John Withers.

25 PRO file IR63/141 p 57.

Conclusion

Given the sorry state of affairs illustrated by this paper, one would like to think that Ministers now always give adequate notice of their intentions, but the state of recent tax legislation indicates that they probably do not. As rushed drafting can easily lead to bad law, what can be done to improve matters? Perhaps Parliamentary Counsel is overstretched and the Finance Bill team needs to be expanded. The greater use of draft legislation would also be helpful. A regular bill making technical corrections could remove anomalies, many of which no doubt would be raised by the Revenue. Some such anomalies relating to accumulated income of settlements were covered in the 1991 consultative document on trusts.[26] Although it was announced that no action would be taken on the consultation documents's proposals, perhaps some should be resurrected for further discussion and possible implementation.

The present system of producing tax legislation has often resulted in muddled and confusing rules which sometimes do not even achieve what was intended and the recent rapid growth in its volume and complexity has exacerbated the problem. It is time to listen to the growing complaints about this and to investigate how we can put in place a better system for achieving high quality tax legislation. The system could not always cope in 1936, and, despite some improvements since then, it is manifestly not coping now. There are many useful suggestions for corrective measures in the latest paper by the Special Committee of Tax Law Consultative Bodies[27] which would make a good starting point for detailed discussions on all sides. Although there has been much criticism of the draftsman, he is not at the root of the problem.

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26 Consultative Document paras 12.30, 12.31 and Appendix A para 58.

27 Recommendations on the Development of Tax Legislation - The Law Society 1993.