DEMERGERS AND TRUSTS

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An article about trusts in a tax magazine? Some mistake surely, as *Private Eye* would say. And yet there's nothing strange about it. Tax law does not live in a vacuum, and the tax lawyer always has to be alive to the oddities of other types of law which may have a bearing on arrangements he is asked to vet. Trusts are a case in point, because trust law can be very odd. Sometimes it is indeed a case of two and two making five; for the subtlety of the trust as a device for separating property ownership into discrete strands allows the tax lawyer regular opportunities to conjure up unforeseen advantages, just as it regularly defeats the efforts of parliamentary draftsmen briefed to prepare taxing structures designed by reference to simpler forms of ownership. An obvious example is the case of capital receipts notionally treated as income for tax purposes; whereas the outright owner has to face a higher rate charge on the receipts in question, the trustee recipient can be expected to face no more than basic rate liability, and there will be no-one else at risk to further tax.

The purpose of this article is to remind the tax lawyer that not every rule of trust law is quite so benign. Sometimes two and two make three. An innocent invitation to participate in arrangements which from the point of the outright owner are no more than a well-conceived attempt at authorized tax planning can, when the taxpayer is a trustee, spring some very nasty surprises. The problem to be discussed in this article is one such case and one which if American commercial patterns are followed in this country may well become increasingly common. A warning note is therefore not out of place.

The problem arises in the context of demergers, of which this country saw several some years back, and which are becoming once more a fashionable tool of commercial strategy in the United States. As is well known, under section 213 and other provisions of the Taxes Act 1988 if certain basic rules are followed the distribution by a company of shares in a subsidiary or the distribution to its shareholders of shares in another company to which it has sold a discrete part of its trade will not constitute a company distribution for the purposes of tax under Schedule F. The demerger thus represents a valuable means of unlocking shareholder value without a liquidation and without fiscal penalty. So far, it seems, so good.

As the name implies, a demerger allows one asset to be turned into two; and common sense says that each is a capital asset, for quite apart from the fact that there is nothing to prevent the demerged shares from representing the large majority of the value of the shares as previously held, the very concept of merger and demerger suggests the existence of two items of equivalent character. To the outright owner it goes without saying that he has two assets where before he had one, and he will feel no doubt that each is on capital account should the question ever arise. But the trustee who assumes the same, as well he might, is in for a nasty shock.

For assuming that the demerger is effected by means of a distribution of the shares in the demerged company as a specie dividend (and so section 213 assumes) then the authorities make clear, or so it is

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commonly said, that the demerged shares go not to capital but to those entitled to the income of the trust. And even if that does not destroy the income tax advantages of the demerger (for it raises the question is there room to argue that the exemption from the Schedule F charge does not prevent a Schedule D Case III charge on the income beneficiary, a question addressed in detail later in this article) it is a conclusion unlikely to endear the trust to the capital beneficiaries.

The fact remains that it is a conclusion apparently justified by high authority. In the Privy Council case of *Hill v Permanent Trustee Company of New South Wales Ltd* [1930] AC 720, at pages 730-731, Lord Russell stated that leaving aside the case of a reduction of capital a company can only make distributions by way of distribution of profits, and therefore *prima facie* where the shareholder is a trustee a company distribution belongs to the income beneficiary of the trust like any other dividend. This principle, which is in essence a rule that the form of the transaction from the distributing company's point of view is conclusive regardless of the substance of the transaction or the true character of the receipt, is one which has been applied consistently in subsequent cases. Thus in each of *re Sechiari* [1950] 1 All ER 417, *re Kleinwort's Settlements* [1951] Ch 860, and *re Rudd's Will Trusts* [1952] 1 All ER 254, the Court was concerned with circumstances in which the company Thomas Tilling had on the nationalisation of the transport industry received a large holding of British Transport stock which it distributed to shareholders as a special capital profits dividend; in each case it was held that *Hill v Permanent Trustee Company* applied to take the dividend to the income beneficiary despite the loss to capital.

Hints have been given that in exceptional circumstances the Court might be prepared to apportion a distribution as between income and capital; but quite how exceptional they would have to be appears to be emphasized in *Kleinwort* (supra) and *re Maclaren's Settlement Trusts* [1951] 2 All ER 414, where it was indicated that capital cannot claim even to share in what is income under the principles laid down in *Hill v Permanent Trustee Company* in the absence of something amounting to a breach of trust. Moreover, both in *Kleinwort* and in *Rudd* the Court rejected the suggestion that apportionment was called for because the trustees ought to have sold the shares in question when the distribution was first proposed so as to avoid the loss to capital; so that argument seems doomed.

But is this view of demergers beyond challenge? No.

For one thing, in practice a demerger (in the lay sense, if not in the language of the taxing statutes) may be achieved not by a distribution of profits by way of a specie dividend but (subject to the sanction of the Court) by a repayment in specie of share premium account; and the Court of Appeal has held that since the enactment of the Companies Act 1948 the rules laid down in *Hill v Permanent Trustee Company* do not apply to a receipt of this nature (see *in re Duff's Settlements* [1951] Ch 923). Thus even on the basis of the current state of authority it is necessary to look to the precise details of the demerging process before the destination of the distributed shares can be discerned.

But there is perhaps even more to be said than that. Why should the demerger not be an exception to the rules laid down in *Hill v Permanent Trustee Company*? In that case at page 733 Lord Russell referred to the case of *Irving v Houston* 4 Paton Sc App 521 as being the only decision of the House of Lords to justify "the view that a person beneficially entitled in remainder to shares in a limited company is entitled to any interest in profits lawfully distributed during the lifetime of the tenant for life by a company not in liquidation". He went on to cite Lord Herschell's view of that case in *Bouch v Sproule* 12 App Cas 385 at p.397 that it was "an authority governing only a case similar on its facts; that is to say a case where the company has no power to increase its capital but has accumulated profits and uses them in fact for capital purposes and afterwards distributes these profits amongst the proprietors". That shows that even if they are to be narrowly confined nonetheless there are exceptions to the rules laid down in *Hill v Permanent Trustee Company*.

In the normal demerger there may be no question of the demerging company lacking the power to increase its capital, so that *Irving v Houston* cannot apply as such; nonetheless, the condition that the profits in question have been used for capital purposes is clearly satisfied, and indeed that is of the essence of the demerging process, so that the case under discussion goes at least halfway to being a special case. Moreover in *Bouch v Sproule* it is emphasized that the question whether a company has converted profits into capital is one to be determined by reference to substance as well as form. There must be room to suggest that there has been a true conversion when the profits in question have assumed the form of the shares of a subsidiary, or where the distribution represents the proceeds of sale of a discrete trade; there can be no more effective conversion into capital, short of the crediting of share capital as fully paid, than the application of funds in an enduring capital concern of the company. So if substance is not to be disregarded the argument for an exception is strong. And however eminent the source it must always be remembered that authorities are not statutory codes; they must be applied in their context. Lord Russell plainly did not have the concept of a demerger in mind; it was as yet unknown. On this ground alone a modern judge might be tempted to take advantage of the rule that a Privy Council decision is not a binding authority, even if persuasive so far as it goes.

Moreover, on a close reading *Kleinwort* leaves a ray of hope for capital beneficiaries. In that case Vaisey J at [1951] Ch 862 stated, in the context of the assertion that there was a jurisdiction to apportion, that "it is no doubt a question of degree". If that is right the black and white rule that appears to emerge from the cases can be seen to be much less clearcut than might have been thought; and it must be a question of asking what if any special circumstances can be found. Suppose, for example, a case in which capital has only recently been used to purchase the shares in question, the demerger has resulted in the shedding of a large part of the company's capital value, and the company already had when the shares were purchased profits available for distribution which covered the distribution made on the demerger: why should not that be a special circumstance? It could not be doubted that in substance the demerger was a capital dealing, because both in terms of the effect of the demerger and in terms of the history of the trustees' investment in the company the profits in question had a capital character. In such a case, considered as a matter of degree the claims of those entitled to capital might well command more sympathy. And the very fact that it has been recognized as a matter of degree rules out the simple riposte that, harsh though it may be, this is just one of the things that has to be accepted by those who benefit under a trust. The Court has a jurisdiction to reach the right result.

In all the circumstances, if demergers by way of dividend in specie are to become a familiar tool of the commercial world, it is to be hoped that sooner or later a trustee will have the courage to raise the issue, either after the event or better still by means of seeking directions how he should proceed when first he becomes aware that he will if action is not taken receive the value of his capital asset in large part in a form which the income beneficiary might claim. At least in the case of a recently acquired asset the merits are surely all on the side of capital; and it may well be that a trustee who simply lets things be, retaining the shares until the distribution is made and then following the authorities, will find that he is not as immune to criticism as he might have hoped. Sooner or later a case is going to arise in which the distribution will be well worth a battle in the Courts. Perhaps it is a case for saying better sooner than later.

And now let us come back to that innocent looking question, to which the answer seems so obvious, whether the Schedule F exemption protects the fortunate income beneficiary against tax[2]. If the answer is no, then common sense is going to have led the trust still further into the mire; not only will the wrong person have acquired the distributed shares, but without even enjoying the benefit of the tax exemption

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[2] and here the author must acknowledge with gratitude the help generously given him by Robert Venables QC on this particular question, as in relation to this article generally.

which capital would have enjoyed.

In the case of the simple trust where a life tenant is entitled to the income as it arises then the exemption seems secure enough; to argue otherwise would be inconsistent with the view of English trust law taken in *Baker v Archer-Shee* [1927] AC 844, and though theoretically Scottish law might be different there seems no realistic possibility of the Revenue taking the point.

What then of the case where the beneficiary takes by virtue of a discretionary interest or under a trust in default of the exercise of a discretionary power? Here the position is very much less secure. For in such a case it is apparently the Revenue view that the exercise of the trustees' discretion represents a separate source of income profit chargeable under Schedule D; if so, there is no reason to suppose that the Schedule F exemption will assist the beneficiary. Furthermore, if there be no exemption the grossing up provisions of section 687 of the Taxes Act would apparently apply, and even if (which is by no means clear) the trustees can escape the charge to basic and additional rate tax the beneficiary will face a higher rate charge on the grossed up sum. So the capital beneficiary will be able to complain of a course of action which has not only cost capital dear, but has not even given the income beneficiary the benefits which capital would have enjoyed; the Revenue has been allowed a slice of the action; and if the trustees have to provide for basic and additional rate tax as well it is no small slice. Arguably capital could say that even if the distribution is rightly treated as income nonetheless the trustees should have retained out of the distribution the amount of the basic and additional rate tax thus leaving in the hands of the income beneficiary a net amount precisely equal to that which would have been the case had the Schedule F exemption not existed, but without the benefit of an ACT credit. Yet that compounds the nonsense.

What then are trustees to do when faced by a proposed specie dividend demerger?[3] In the absence of any special power they may say that they ought to sell the shares to avoid loss of capital; but if they do so they face capital gains tax which might have been deferred by following the demerger route, so that is not necessarily the easy option that it seems. Probably the best course for the simple trust with a single life tenant is to obtain the life tenant's consent to the retention of the shares yielded by the demerger as capital, on the basis that if he does not consent the whole investment must be sold; by analogy with the result in *Maclaren's* case (supra) that course of action would seem to resolve the problems. Of course, the life tenant has to co-operate; but he may well perceive that the sale of the investment despite the capital gains tax charge is a more acceptable consequence than the prospect of a windfall for income at capital's expense, and if so then he is unlikely to overplay his hand. If the income is liable to be dealt with at discretion and the trustees are not simply prepared to sell their investment then they may well have to seek the directions of the Court, but in such circumstances the Court may well be prepared to direct that the shares received be retained as part of capital when it emerges that the alternative involves not only the loss of capital but substantial loss of tax as well (and it might even be possible to devise a question of construction which could be compromised on terms that enabled the income beneficiaries to take a little compensation at the expense of capital without the benefit being taxed as income, thus avoiding the very real danger, if matters are allowed to proceed without directions, of a pint being all that is left in a quart pot).

But best of all would be the possibility of a question arising in a case of such substance that the existing

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3 It goes without saying that the first thing they ought to do is to look to see whether the draftsman of their settlement foresaw the problem, but alas such foresight is rare, above all since the introduction of capital transfer tax filled all careful draftsman with the terror of doing anything that might be held to prevent an interest from subsisting in possession by giving the trustees a discretion to treat income as capital.

wisdom could be challenged and the law be cured of a rule in which some eyes may detect a faint resemblance to Bottom in his salad days. It is one thing to talk, as the cases do, of a windfall benefit to the income beneficiaries, as if such things are amongst the accidents of life; it is quite another to see a tree deliberately split in two and then to be asked to believe that one part of the tree is really a species of fruit, for no better reason than that what comes off a tree is normally fruit. The demerger is not a normal case, and should not be treated as one.