TRUST MANAGEMENT EXPENSES – AND MUCH MORE

The Revenue Paper of 31st January 2006

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Introduction

On 31st January 2006, Her Majesty's Revenue and Customs published a guidance paper called "Trust Management Expenses Guidance", to which I shall refer as "the Guidance". The title is modestly deceptive in that the Guidance sets out the Revenue's views on a number of matters which involve rather more than the tax treatment of trust management expenses.

The paper is refreshingly lucidly written. Whether one agrees with it or not, it is at least tolerably clear and generally free of ambiguity.

Much of what is said is uncontroversial. Some of the paper is highly debatable. Some of it is in, in my view, perhaps rather more favourable to taxpayers than is warranted in strict law. And some of it is just wrong. Most importantly, it contains some very important statements relating to the taxation of beneficiaries of interest in possession trusts of what I have always considered to be the law but could not be regarded as beyond argument. It is very welcome to see these confirmed in print, particularly as sophisticated tax planning strategies sometimes rely on them.

It would appear that none of the content will be overtaken by the reforms to the taxation of trustees and their beneficiaries announced on the same day, which will

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take effect in general from 6th April 2006. Nor would I expect it to be overtaken by those reforms, particularly relating to income streaming and the phasing out of the tax pool, which have, wisely, been postponed to some later date.

I very much get the impression that the author has in mind only trusts the trustees of which are resident in the United Kingdom and which are governed by English proper law. It should be borne in mind that the position could be very different if either of those conditions were not satisfied.

In this article, I shall set out key parts of the paper in *italics* and then comment on them in regular type. I, too, shall assume that the trustees of the trust in question are United Kingdom resident and that the trust is governed by English proper law. I shall also, except where otherwise indicated, assume that the beneficiaries are domiciled, resident and ordinarily resident in the United Kingdom.
I shall also consider to what extent the decision of the House of Lords in *Carver v Duncan* [1985] STC 356 might have been overtaken by developments in generally accepted accounting practice.

I should warn the reader at the outset that much of what is said is irrelevant where income arising under the settlement is deemed by some anti-avoidance provision to be that of the settlor for income tax purposes. While that important point is quite properly made in the Guidance, it is rather buried away and does not receive the prominence it deserves.

The Guidance

SECTION 1 GENERAL POINTS

1.1 This guidance applies to 2005-2006 and subsequent returns of income for trustees of accumulation/discretionary trusts and income beneficiaries of interest in possession (IIP) trusts. The trustees and beneficiaries should make their returns according to these guidelines.

No trustee or beneficiary is, of course, obliged to make any return according to the guidelines. If they do not, it might be appropriate to bring the fact to the attention of the Revenue in the return or covering letter. In my view, provided the return is in accordance with Revenue guidelines, the Revenue can hardly complain if trustees or beneficiaries return less tax as being due than they or their professional advisers consider might be the case.

1.2 The guidance has been largely agreed by trust representatives, but some areas of disagreement remain, in particular trustees' fees.

It is not made clear who these "trust representatives" are or what their competence is. The fact that they may have agreed parts of the Guidance does not, of course, affect the position in law of any one else.

1.3 The guidance reflects HMRC's current position. We are aware of the Law Commission paper 175, Capital and income in Trusts: classification and apportionment. HMRC's position is unaffected by long-term plans of the Law Commission. If any part of our position is ultimately affected, then we will revise it accordingly.

Fair enough.

'Allowable TMEs'

1.4 In this paper TMEs are referred to as being 'allowed' and as 'allowable TMEs'. Those phrases are used to mean trust management expenses that are to be taken into account for tax purposes in order to:

- *tax accumulation/discretionary trustees at rates lower than the special trust rates in Section 686 ICTA 1988*
- *arrive at the net amount of an IIP beneficiary's income.*

In each case they are 'allowed' or 'allowable' in that they ultimately reduce tax.

It is probably true that in the majority of cases TMEs will probably reduce tax. Yet that is by no means a foregone conclusion. For grossed-up income used to meet TMEs will be taxable at the "ordinary rate" (i.e. the basic rate, the savings rate, of the dividend ordinary rate, depending on the type of income); whereas if income belongs to a beneficiary entitled to an interest in possession it will be taxed at his marginal rate and according to his personal circumstances. Indeed, if the income has a foreign source and the beneficiary is either non-UK resident or non-UK domiciled, it may escape United Kingdom income tax altogether if it belongs to him

Expense or distribution

1.5 To be an allowable TME, an item must at least be an expense. Not all payments out of the trust (that is payments that release the sum paid from the terms of the trust) made by trustees can be categorised as expenses. Some are distributions. Sometimes it is not obvious that a payment out of the trust is not an expense but is in fact a distribution. A distribution is a *payment out of the trust that is either itself a gift made directly to the beneficiary, or is payment to a third party that procures a benefit for a beneficiary (as distinct from a benefit to the trust funds).*

1.6 Therefore not only is a payment of cash or a grant to a beneficiary a distribution, but so also is the payment of the costs of procuring a benefit in kind for a beneficiary, such as

- *the payment of a beneficiary's utility bills*
- *the cost of providing gifts, medical treatment, support or entertainment to beneficiaries.*

1.7 Distributions are not expenses, and so are never allowable TMEs.

While one could quibble with the wording, the substance of these sections is sound. There is sometimes a factual difficulty in distinguishing which side of the line a payment falls. Indeed, it could be a mixture of the two.

TMEs are unique

1.8 TMEs are not like any other expenses for tax purposes.

1.9 There is a common misconception that they are on a par with tax deductions for trading. Where a trust carries on a trade, the normal trading income rules apply to the computation of the profit/loss of that trade. In contrast, TMEs are expenses incurred in the capacity of trustee, not in any other capacity such as a trader. They are not related to the expenses or deductions of a trade or rental business. Even if a large trust is run like a business, for TMEs purposes the rules for allowable trading deductions are not in point. A separate set of principles, legislation and case law apply.

1.10 TMEs are the expenses of managing the trust, not the computation of the profit/loss of a trade. The more common tax notions of 'capital' and 'income', e.g. construction of a new building versus repairs, do not apply. What is relevant is 'capital' and 'income' in trust law.

1.11 The allowance of TMEs for tax purposes is based to a large extent on trust law. This paper describes the trust law position and goes on to explain how tax considerations affect that basic position.

This is so far broadly correct. It is important to distinguish between expenses which are deductible in computing taxable income and those which are not. The rules applicable to the deduction of this first category of expenses are no different in the case of trusts than they are, say, in the case of individuals. When one is asking whether a TME is "allowed" for tax purposes, one is looking to an expense which an individual owning the source(s) of income of the trustees would not be able to deduct at all.

Trustee remuneration is a very interesting area. Let us suppose that a trust owns substantial rental properties and that a trustee receives substantial trustee remuneration which in part compensates him for acting as managing agent of the properties. Such part of his remuneration as is referable to those activities ought to be deductible in computing the trust's interest from land, just in the same was as if he had been employed by an individual to act as managing agent of properties which the individual owned absolutely. It the trust carries on a trade and the trustee is in part remunerated for his activities in the course of that trade, similar considerations apply. It is only the part of a trustee's remuneration which is not paid for earning taxable income or which is non-tax deductible in computing such income which one needs to consider as a TME.

SECTION 2 TMEs IN TRUST LAW

Trust management expenses in trust law

2.1 In managing a trust the trustees may incur expenses in the course of exercising their duties and powers. These are to be distinguished from payments made to beneficiaries (distributions). Expenses may be referred to as 'capital' or 'income' expenses, depending on which fund they are to be paid out of.

2.2 For an expense to be properly chargeable to income in trust law the trustees must have authority to put the final burden of that expense on the income fund.

2.3 As described in Carver v Duncan, 59 TC p. 144, at point 7.5, the administrative powers of trustees derive from four sources: the general law, statute, the trust instrument, and the Court.

2.4 In trust law an order of the Court is conclusive as against all the other rules. Subject to that, the provisions of a trust deed are usually conclusive as to the remaining rules. If the trust deed is silent, then any statute *dealing with the incidence of trust expenses must be considered, and in the absence of that the trustees look to the general law for guidance.*

2.5 *Applying the above to the consideration of which fund expenses are to be paid out of, capital or income, trust law looks at the four sources in the following order*

- *an order of the Court in a specific case*
- *the provisions of the trust deed*
- *statute law as to the incidence of a particular category of expense*
- *general law in the field of trusts and equity (including principles to be discerned from case law).*

This is by and large a reasonable approach.

Case law on expenses - income vs. capital expenses

2.6 *The main case on trust management expenses is Carver v Duncan, 59 TC 125. Lord Templeman explains that the issue in that case involved the consideration of two issues:*

- *the trust question of the incidence of trust expenditure as between income and capital;*
- *and the tax question of the deductibility of expenses for the purpose of calculating income chargeable to what are now the special trust rates in S686 ICTA 1988.*

The case did not touch on tax aspects of interest in possession trusts.

While it is right to point out that *Carver v Duncan* "did not touch on tax aspects of interest in possession trusts", it is by no means completely irrelevant so far as such trusts are concerned.

Carver v Duncan is in some ways a difficult case. It was concerned with the deductibility of certain payments made by trustees out of trust income in ascertaining the quantum of the net income of the trust subject to tax at what is now the "rate applicable to trusts" or RAT. In so far as it determined that, in order to be so deductible, a payment must be both chargeable to income account under the general law of trusts *and* under the particular provisions of the trust instrument in question, it was a perfectly possible decision. In so far as it decided that the payments of premiums on a policy of life assurance which was in effect an investment of the trust[2] were not, as a matter of the general law of trusts, chargeable to capital, it is difficult to fault. In so far as it decided that recurrent payments made to investment advisers for keeping a trust's investments under review were, as a matter of the general law of trusts, chargeable to capital, it looked a little odd at the time it was decided (1985). In so far as it indicated that certain other recurrent payments were chargeable to capital and not to income, it looked more than a little odd. And with the passage of time, the decision looks odder still.

The Revenue rightly point out (in section 1.9) that when dealing with TMEs we are not concerned with the rules for the deductibility of expenses in computing the profits of a trade. So that Income Tax (Trading and Other Income) Act 2005 section 25 (Generally accepted accounting practice) is not in point.[3] However, I suspect that the Courts would nowadays hold that the rules relating to what expenses are, as a matter of trust law, chargeable to capital and what to income must to some extent take account of current accountancy practice and that they are not to be bound by rules laid down in the 19th century. Some of the views expressed by the House of Lords in *Carver v Duncan* are, if read literally, plainly at odds with current accountancy practice. In my view, they should not be read literally. I give my reasons in my commentary on subsequent sections of the commentary.

2.7 What follows here is a summary of our understanding of the general principles of the case about the first (trust) question, drawn from the judgements referred to. A summary of the principles in the case about the second (tax) question relating to accumulation/discretionary trusts is contained in section 4.

2.8 In trust law, trustees are entitled to be indemnified out of the capital and income of their trust fund against all obligations incurred by them in the due performance of their duties and the due exercise of their powers.

True, but this takes the matter no further.

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2 Different considerations might apply to different types of insurance policy, even to different types of life policy.

3 Section 25(1) provides: "25(1) The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for income tax purposes."

2.9 The trustees must debit each item of expenditure either against income or against capital.

True again, but the vital question is "Which?" and do they have a discretion?

2.10 The general rule in trust law is that income 'must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and incumbrances' while capital 'must bear all costs, charges and expenses incurred for the benefit of the whole estate'. At this point Lord Templeman is addressing only the first issue, the trust law position. He is not saying anything about the tax position.

It is true that Lord Templeman is here addressing only the first issue.

An immediate difficulty which confronts one in that it is true of some payments that they are *both* "ordinary outgoings of a recurrent nature" *and* "costs, charges and expenses incurred for the benefit of the whole estate". The dichotomy is a false one. Take for example, regular repairs to real property.[4] They are clearly incurred for the benefit of the whole estate. For if they are not made, the capital value of the estate will be diminished. Yet which of us would doubt that they are of an income nature? And this view is accordance with established accountancy practice. Why is that? In my view, it is because they do not so much increase as *preserve* the value of the trust fund.[5]

It would be wrong to read Lord Templeman's dictum too literally. Inheritance tax, for example, is clearly a tax on capital and ought to be charged to capital. I am sure that Lord Templeman would not disagree and would say that he had in mind only annual taxes.

2.11 Lord Templeman refers to In re Bennett (1896) 1 Ch 778, for the meaning of 'ordinary outgoings'. 'By an outgoing is generally meant some payment which must be made in order to secure the income of the property.'

In re Bennett was a very special case. Superficially, one might consider, that it decided that the costs of audit of trust property are payable out of capital, which is,

4 i.e. normal repairs, and not ameliorating repairs.

5 Admittedly, it will often be the case that no problem will arise in a *tax* context, where the cost of such repairs is deductible in computing trading income or income from land and thus will not rank as TMEs. However, that does not detract from the force of the example in considering what is chargeable to income as a matter of *trust* law.

of course, entirely at odds with current accounting practice.[6] Yet the facts were very peculiar. The trust fund included the benefit of a debt lent to a partnership on terms that the creditor could audit (at his own expense) the partnership books and would have the right to call in the debt if there were doubts as the solvency of the partnership. As Kay LJ said:

> "… the object of the provisions in the agreement is to ensure repayment of the capital. If the trustee finds that a breach has been committed of any of these provisions, then his duty will be to call in the capital sum at once, and he cannot tell whether or not there has been a breach without an examination of the books. Surely that is a provision which the testator deliberately introduced into this agreement for the purpose of making himself safe as to the repayment of this capital which he had not charged in terms upon the capital of the business."

It was only Lindley LJ who observed "By an "outgoing" is generally meant some payment which must be made in order to secure the income of the property." That was a very general dictum which will not bear too close scrutiny. Are rates and taxes, for example, paid to secure the income of the property? Are damages in tort? Are the costs of making a self-assessment return of income? Yet who would deny that these are all chargeable to income.

Counsel for those interested in capital had pressed the analogy with premiums of insurance against damage by fire which by statute[7] were payable out of income. It is interesting that the court did not state simply that the matter was governed by an express statutory provision which could throw no light on the normal rules of Equity. Instead, two of the judges distinguished the position for totally unconvincing reasons.

Kay LJ said:

> "Mr. Thompson ingeniously likened the case to one of insurance. The analogy is not good, for one reason, because, in the case of insurance, the premium bears a very small proportion indeed to the value of the property insured, and the premium on £15,000 would not be anything like £213 a year, which is the estimated expense of each examination of the books."

Yet it is difficult to see how a question of principle can be decided on the quantum of the outgoing or the proportion it bears to the gross income of the trust fund.

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6 The position regarding audit of the accounts of the trust property is now governed by Trustee Act 1925 section 22(4).

7 Then Trustee Act 1893 section 18; now Trustee Act 1925 section 19.

A. L. Smith LJ said:

> "*the difference between the two cases is this, that in the case of insurance the payment is a voluntary one made by the tenant for life out of his own income without any obligation on his part to do so at all.*"

Before *Carver v Duncan*, I could not understand this at all. The statute said in express terms:

> "A trustee may insure against loss or damage by fire any building or other insurable property to any amount (including the amount of any insurance already on foot) not exceeding three equal fourth parts of the full value of such building or property, and pay the premiums for such insurance out of the income thereof or out of the income of any other property subject to the same trusts, *without obtaining the consent of any person who may be entitled wholly or partly to such income.*"

The whole point being made was that the payment was not a voluntary one by the tenant for life. Lord Templeman in *Carver v Duncan* quoted this passage without any adverse comment and apparently approved of it. I am quite unable to see why.

I would have thought that the fact that Parliament expressly provided, as early as 1893, that fire insurance premiums should be payable out of income, notwithstanding that they were clearly paid for the benefit of the capital of the estate and that any proceeds of the policy would be capital, ought to have made the Court of Appeal in *In Re Bennett* in 1896 or, at any rate, the House of Lords in *Carver v Duncan* in 1985, pause to ask whether the dictum of Lindley LJ, eminent expert as he was on the law of trusts, was really adequate. In my view, annual fire insurance premiums are like recurrent repairs[8] in that they are paid to preserve capital rather than to increase it. Both should as a matter of principle be chargeable to income, notwithstanding that they (potentially) benefit capital.

2.12 *The fact that something is recurrent does not necessarily mean it is of an income nature. The annual premiums in Carver v Duncan were 'a recurrent charge but not an ordinary outgoing', and remained capital.*

Agreed.

2.13 *In re Bennett (1896) 1 Ch 778 affirms the trust principle that expenditure incurred for the benefit of the whole estate is a capital expense.*

8 Lord Templeman uses the term "casual repairs", which he clearly considers to be chargeable to income.

I have already discussed at 2.11 how misleading this test is. In any case, it is not the ratio of *In re Bennett*.

2.14 In sum, Carver v Duncan establishes that anything expended for the benefit of the whole estate, that is both income and capital, is to be charged to capital. There is no suggestion in case law that there is any basis for apportioning expenses that are incurred for the benefit of the whole estate into income and capital costs. This is a trust law principle affecting both accumulation/discretionary trusts and IIP trusts.

Carver v Duncan establishes nothing more than that two types of payment were in 1985 chargeable to capital, namely premiums on policies of life insurance which would one day mature and produce a capital sum and fees paid to investment advisers for certain services. It is a truism that if expenses indeed fall to be charged to capital, then they are not to be apportioned partly to income.

2.15 Annual fees paid to a firm of investment advisers to keep under review and to advise changes in investments comprised in the trust fund are also capital, as established in Carver v Duncan. Such fees 'are incurred for the benefit of the estate as a whole because the advice of the investment advisers will affect the future value of the capital of the trust fund and the future level of income arising from that capital.' This confirms that even if income is affected, the item remains chargeable to capital because it is for the benefit of both income and capital.

This may well be correct. However, in many, if not, all, cases, it should be possible for the expense to be deducted as the part of the cost of acquiring or disposing of an asset in computing the chargeable gain for capital gains tax purposes. See Taxation of Chargeable Gains Act 1992 section 38.

2.16 Carver v Duncan also establishes that income bears the cost of 'ordinary outgoings', which are payments made 'in order to secure the income of the property'. That is, they are not made in order to distribute the income or apply it in any way, but to 'secure' it.

I have stated that *Carver v Duncan* must have a rather more limited effect than the Revenue suppose and that not only those expenses which are incurred to “secure” income can be properly chargeable to income. In particular, I would have thought that as a matter of general principle recurrent expenses of the trustees which are not aimed at acquiring or enhancing (as opposed to preserving) the value of any capital asset comprised in, or of otherwise increasing the value of, the trust fund should be prima facie chargeable to income account.

SECTION 3 TMEs FOR TAX PURPOSES

For tax purposes, TMEs are taken into account as follows:

> *Allowable TMEs in accumulation/discretionary trusts (that is, trusts subject to Section 686 ICTA 1988) are allowed in determining how much of the income is chargeable to the rate applicable to trusts (RAT) or the trust dividend rate, so far as they are allowed by tax legislation. They are not taken into account in the taxation of the beneficiaries of accumulation/discretionary trusts.*
>
> *Allowable TMEs in interest in possession (IIP) trusts are allowed in measuring the income of the beneficiary for tax purposes. They are not taken into account in the taxation of the trustees.*

Agreed.

TMEs and basic rate, etc. tax

3.2 *In taxing the trustees of an accumulation/discretionary trust or an IIP trust at rates up to basic rate, the usual deductions against various sources of income (e.g. deductions to arrive at net trading profit or rental income) are allowed. But the trustees do not get relief at those rates of tax for any 'trustees' expenses' whatsoever.*

3.3 *The tax case of Aikin v Macdonald's Trustees (3 TC 306--1894), concerned with income remitted to the UK from abroad, confirmed the general principle that trust management expenses are not to be taken into account in arriving at the measure of taxable income of the trustees. The case found that the full amount of income received in the UK was taxable without any deduction in respect of expenses incurred in this country in managing the trust. As Lord McLaren said, 'the only kind of deductions allowed is expenditure incurred in earning the profits. There is no deduction under any circumstances allowable for expenditure incurred in managing profits which have already been earned and reduced into money' (p309).*

Agreed

Comparison of accumulation/discretionary trustees with IIP beneficiaries

3.4 In an accumulation/discretionary trust, whether something is allowable for tax purposes is relevant as it reduces the amount of the trustees' income assessable to the RAT or the trust dividend rate.

True.

3.5 In an IIP trust, the income beneficiary is entitled to the income as it arises out of trust assets, with the exception of any part of that income that is properly paid away on trust expenses and some other items. TMEs are considered as part of establishing what net income the beneficiary is entitled to in law. That entitlement then provides the measure on which to tax the beneficiary. So 'allowable' TMEs, in this case, do not constitute a tax deduction, because they represent sums of money that the beneficiary was not entitled to in the first place.

This paragraph, read in isolation, is ambiguous. It is true that if TMEs are, as a matter of trust law, chargeable to income, then they are taken into account in establishing to what actual net income the beneficiary is entitled as a matter of trust law. Yet that is not necessarily the amount of the beneficiary's taxable income. What is true is that the beneficiary entitled for an interest in possession cannot in principle be taxable on income to which he is not entitled and income which is required by the trustees to pay expenses properly chargeable to income is not income to which the beneficiary is entitled. Yet the beneficiary's taxable income can be less than his actual income because the trustees' taxable income is less than their actual income. This will be the case where the trustees are entitled to capital or other allowances or reliefs, such as relief for carried-forward losses, in respect of which there is no corresponding payment out of current income.

3.6 For an accumulation/discretionary trust the tax legislation for TMEs is in Section 686(2AA) ICTA 1988. This section limits what is allowable as a TME by providing that the provisions of the trust deed should be ignored when looking at expenses. Section 686(2AA) also limits allowable expenses to 'expenses of the trustees'. Only three of the four sources of the trust law rules on expenses (as described in paragraph 2.3) are relevant, and the extent of case law involving discretionary/accumulation trustees and TMEs is in fact very limited. Most of the case law relates to IIP trusts.

Section 686(2AA) provides:

> "(2AA) The rate at which income tax is chargeable on so much of any income arising to trustees in any year of assessment as–

(a) is income to which this section applies, and

(b) is treated in accordance with section 689B as applied in defraying the expenses of the trustees in that year which are properly chargeable to income (or would be so chargeable but for any express provisions of the trust),

shall be the rate at which it would be chargeable on that income apart from this section, instead of the rate applicable to trusts or the dividend trust rate (as the case may be)."

It is not immediately obvious why an order of the court should be conclusive. The court might, for example, have decided that while expenses would under the general law be chargeable to capital, yet under the provisions of the trust instrument they are chargeable to income.

3.7 *By contrast, with an IIP trust, there is no tax legislation relevant to the general principles applying in such cases. Relevant case law must be relied upon. All four of the four sources of the trust law rules on expenses (as described in paragraph 2.3) are relevant, including the provisions of the trust deed.*

True.

3.8 *While 'allowable TMEs' to some extent means the same thing when applied to discretionary/accumulation trustees and IIP beneficiaries, due to the differences summarised above, there are divergences.*

True.

SECTION 4 PRINCIPLES OF TMEs IN ACCUMULATION/DISCRETIONARY TRUSTS

Relief against the special trust rates

4.1 *The trustee of an accumulation/discretionary trust is chargeable at special trust rates on income 'which is to be accumulated or which is payable at the discretion of the trustees or any other person' - Section 686(2)(a). The rates are 32.5% for dividend type income, and 40% for other income. However, S686(2AA) provides for relief, at the difference between the special trust rates and other, lower rates, on income that is used to defray expenses of the trustees that are properly chargeable to income.*

4.2 *There are certain situations where items that are capital in trust law are deemed to be income for tax purposes, and are also taxable at the special trust rates. If the item is liable to tax at the special trust rates by virtue of being 'treated as income to which S686 applies', for example as in S686A(3) ICTA 1988 (company purchase of own shares) then the trustees are also entitled to relief for allowable TMEs under S686(2AA) against that deemed income. If the deemed income is liable to tax at the 'rate applicable to trusts', for example S720(5) ICTA 1988, then there is no basis for relief under S686(2AA), as there is no connection with S686 itself.*

4.3 *The relief given by Section 686(2AA) is not an optional relief that has to be claimed, but is part of the rules by which the trustee's tax liability is to be calculated. The use of the word 'shall' indicates that this is a mandatory step in the tax calculation.*

I am myself rather sceptical that section 686(2AA) provides relief in respect of TMEs which are chargeable to capital as a matter of trust law. However, it will not be in anyone's interest to disagree with the Revenue's published view.

How relief is given – grossing up

4.4 *For income tax purposes, any expenses of the trustees' payable out of income are understood to be paid out of income after it has suffered tax at the dividend ordinary rate, lower rate or basic rate. … Consequently, so much of "any income arising to trustees" (see opening words of Section 686(2AA)) as is "applied in defraying expenses of the trustees" (see Section 686(2AA)(b)) must be an amount of income sufficient to meet both the expenses in question and the appropriate basic etc. rate tax on that amount. Hence the income out of which allowable TMEs are paid is grossed up at the appropriate rate or rates to establish the deductible amount for the purpose of setting against the special trust rates.*

While in my view correct, and while so much had been conceded by the Revenue in *Carver v Duncan*, it is helpful to see the Revenue's view unambiguously set out.

Order of set-off

4.5 *S689B provides the order in which expenses are to be set against income. Allowable TMEs are set against income chargeable to the special rates of tax in this order:*

- *first, against income that carries a notional or non-payable ordinary dividend rate tax credit of 10%, for example dividends from UK companies, then*

- *any excess against income taxable or carrying a tax credit at the lower rate of 20%, for example interest from a UK bank, finally*

- *any excess from income taxable at the basic rate of 22%, for example income from property.*

[An example is then given.]

This statement (and the example) correctly states the position.

Tax legislation - Section 686(2AA)

4.7 Section 686(2AA) allows relief for income that is

- *applied in defraying*

- *the expenses of the trustees*

- *in that year*

which are properly chargeable to income (or would be so chargeable but for any express provisions of the trust).

'Applied in defraying'

4.8 The statute clearly refers to income treated as being 'applied in defraying the expenses'. The use of 'defraying' means that the amounts must actually be paid to be taken into account. It is not enough that they are incurred. So allowable TMEs are taken into account in so far as they are paid in the year for which the return is made.

It seems to me that this interpretation is probably based on a misreading of section 686(2AA). The subsection in fact refers to "so much of any income arising to trustees in any year of assessment as–

(a) is income to which this section applies, and

(b) is treated in accordance with section 689B as applied in defraying the expenses of the trustees in that year which are properly

> chargeable to income (or would be so chargeable but for any express provisions of the trust)"

As a matter of plain English, the adverbial phrase "in any year of assessment" clearly governs the words "arising to trustees" and not "is treated in accordance with section 689B as applied in defraying the expenses of the trustees in that year". Of course, when it comes to the construction of statutes, the higher judiciary are not beyond ignoring plain English.[9]

Nor is there anything in section 689B (Order in which expenses to be set against income) which drives one to a different conclusion. Section 689B(1) provides:

> "(1) The expenses of any trustees in any year of assessment, so far as they are properly chargeable to income (or would be so chargeable but for any express provisions of the trust), shall be treated-
>
> (a) as set against so much (if any) of any income as is income falling within subsection (2), (2A) or (3) below before being set against other income; and
>
> (b) as set against so much (if any) of any income as is income falling within subsection (2) or (2A) below before being set against income falling within subsection (3) below and
>
> (c) as set against so much (if any) of any income as is income falling within subsection (2) below before being set against income falling within subsection (2A) below."

Indeed, section 689B is directing one's attention solely to the expenses of trustees in any year of assessment which are properly chargeable to income, not to sums paid in any year to defray expenses which are chargeable to income, whether in that or some other year.

While I thus consider it highly likely that the Revenue view is wrong, it could be quite useful to trustees to be able to rely on it in circumstances where there is not enough income in a year to pay trust expenses chargeable to income. See 4.11 below.

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9 See my article *"Post Dextra Tax Planning"* concerning *Dextra Accessories Ltd and others v Macdonald*, which appears in the current issue of *The Corporate Tax Review* and will be reproduced in the next issue of *The Personal Tax Planning Review*.

'Expense of the trustees'

4.9 To meet the requirements in Section 686(2AA), the expense must be an expense of the trustees. It must arise from the role of trustee, and occur in the course of exercising the duties and powers of a trustee, not from any other role such as trader.

This concept of an expense arising "from the role of trustee" is an obscure one which has no basis in statute or case law and explains nothing. The real test in my view is whether the expense has already been deducted in computing taxable income to which section 686 applies. If it has, e.g. because it has been allowed as a deduction in computing trading profits, then section 686(2AA) cannot apply to it. For it is not "chargeable to income": it has already been deducted in computing "income" It is true that on this view "income" must mean "taxable income" on each of the four occasions on which it occurs in the subsection, which admittedly does not fit altogether easily with the trust law concept of an expense being chargeable to income. However, it is inconceivable that the Courts would permit any other construction and the infelicities of drafting of section 686 are notorious.[10]

In many cases, it will not matter whether one follows the Revenue's formulation or mine. However, it will be crucial in those cases where a trading expense which an accountant would carry to the profit and loss account is expressly made non-deductible for income tax purposes e.g. expenses of entertainment or bribes.

See also 4.19 of the Guidance and my commentary thereon.

'In that year'

4.10 This phrase refers back to the start of S686 (2AA) which refers to 'income arising to trustees in any year of assessment'. So relief for allowable TMEs is given on the basis of the tax year in which they are paid.

The second sentence is a complete *non-sequitur* and in my view plainly wrong. See my comment on 4.8 above

4.11 Sometimes the trustees borrow from the trust capital to pay income expenses, or vice versa. In a year where there is not enough income and trustees borrow from capital to pay income expenses, the amount paid from income will reduce the income taxable at the special trust rates to nil. The amount taken from capital to meet the deficit will be an allowable TME for

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10 They were acknowledged by the Court of Appeal in *Howell v Trippier* [2004] EWCA 885 [2004] STC 1245, in which I appeared as Leading Counsel for the taxpayer trustees.

the year in which the trustees reimburse capital from income for those income expenses.

It seems unconceivable that this statement is one with which any taxpayer trustees would wish to disagree. Yet the reasoning is less than convincing. Trustees do not "borrow" from capital. Moreover, it is an interesting point whether trustees are entitled as a matter of trust law to use income of a subsequent year to make good an income loss of a previous year.[11] Moreover, this tax treatment depends on deductions being available in the year of *payment* (as to which see my commentary on section 4.8 above) and as treating sums paid by trustees out of capital as not in fact paid until there is enough income to make good the capital.

'Properly chargeable to income'

4.12 S686(2AA) provides for relief for trust management expenses that are 'properly chargeable to income (or would be so chargeable but for any express provisions of the trust)'[.] The full meaning of this is explained in Carver v Duncan 59 TC 125.

4.13 In that case, the trust deed allowed the trustees to pay certain expenses that were normally capital in trust law out of income. Lord Templeman said that although a settlor may provide that capital expenses shall be paid out of income, the settlor cannot alter the nature of those expenses.

This is broadly correct.

4.14 Lord Templeman went on to examine the second 'problem' in the case, the tax problem of the deductibility of expenses for the purpose of calculating income chargeable under what is now S686.

4.15 He said 'In my opinion, [S686(2AA)] allows deduction of expenses properly chargeable to income, that is to say, income expenses. The words in brackets are explanatory and are placed in brackets because they are merely explanatory; they remove any possible ambiguity in the expression 'properly chargeable' by emphasising that expenses which are deductible are those which would be chargeable to income in the absence of any express provisions of the trust. The natural construction of [S686(2AA)] seems to me to authorise the deduction of income applied in defraying income expenses but not income applied in defraying capital expenses. This

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11 The question would arise in an acute form if a beneficiary were entitled to an interest in possession in year 2, e.g. because an Accumulation and Maintenance trust had ripened into an interest in possession trust on the beneficiary attaining a specified age.

> *construction is consistent with trust law, consistent with income tax law and consistent also with common sense.'*

The decision in *Carver v Duncan* was on Finance Act 1973 section 17, the parent of Taxes Act 1988 section 686. In its original form, section 686 followed section 17 quite closely. In particular, subsection (2) provided that for section 686 to apply to income arising to trustees it must satisfy the conditions in paragraph (a), (b) (c) and (d). The condition in paragraph (d) was that the income "exceeds the income applied in defraying the expenses of the trustees in that year which are properly chargeable to income (or would be so chargeable but for any express provisions of the trust)". Lord Templeman and a majority of the House of Lords held that this referred to "the income applied in defraying the expenses of the trustees in that year which are properly chargeable to income *and* would still be so chargeable despite any express provisions of the trust". The decision involved forcing the language. The natural meaning of the words can hardly admit of any doubt. They clearly covered income which is *either* applied in defraying the expenses of the trustees in that year which are properly chargeable to income *or* would be so chargeable but for any express provisions of the trust which provided that they should be charged to capital. However, there was an arguable case for straining the language to admit of a perhaps more sensible purposive construction. And that is what Lord Templeman did.

What the Guidance does not mention is that section 686 was recast by Finance Act 1997 (with effect from 1996/97). The condition in section 686(2)(d) was repealed, so that section 686 in terms applies even to income which is applied in defraying trust expenses. However, section 686(2AA) was added, which provides the *rate* at which certain income of the trustees should be charged to tax should (notwithstanding that section 686 applies to it) by "the rate at which it would be chargeable on that income apart from this section".

To which income does section 686(2AA) refer? It is "income … as … (b) is treated in accordance with section 689B as applied in defraying the expenses of the trustees in that year which are properly chargeable to income (or would be so chargeable but for any express provisions of the trust). This takes us to section 689B, which provides:

> "(1) The expenses of any trustees in any year of assessment, so far as they are properly chargeable to income (or would be so chargeable but for any express provisions of the trust), shall be treated–
>
> (a) as set against …"

It seems to me that the words “properly chargeable to income (or would be so chargeable but for any express provisions of the trust)” would be given the same interpretation as in what was to come to be the now repealed section 686(2)(d), so that the Finance Act 1997 changes did not make any difference in this respect and *Carver v Duncan* is still relevant. Hence, the Guidance is correct.

4.16 So for S686(2AA) purposes, we ignore the provisions of the trust deed. If under the particular terms of the deed, the trustees pay some expenses that are capital in general trust law out of income, they are not allowable for Section 686(2AA) purposes.

Agreed, for the reasons given at 4.15.

Income expense - difference between trust law and Section 686(2AA)

4.17 Expenses that are income expenses for trust law are not necessarily income expenses that are allowable for Section 686(2AA).

4.18 First, an expense may be an income expense for trust law because the trust instrument authorised the trustees to put the final burden of the expense on the income fund. However, Section 686(2AA) directs that what the trust instrument has to say about the incidence of a particular expense should be ignored, as explained above in 4.16.

4.19 Secondly, some trust law income expenses may have already been allowed elsewhere in the tax calculation before Section 686(2AA) is applied. For example, the trustees may pay rates on a rental property. Carver v Duncan says that 'rates' are income expenses for trust law purposes. But they are already taken out of the charge to the special trust rates by provisions associated with rental income. The sum used to defray these expenses is not brought into charge for the special trust rates at all, and as such is incapable of being an expense for the purpose of Section 686(2AA).

Although the wording of the statute could be much clearer, the courts would be bound to agree with this approach. For it would be illogical for trustees to obtain a double deduction for an expense. See also my comment at 4.9.

4.20 Thirdly, some expenses may be income expenses as a matter of trust law but cannot be allowable for tax purposes on general tax law principles. For example, Carver v Duncan says that 'taxes' are an income expense in trust law. But taxes are not a deduction in arriving at tax liability, and so not allowable for Section 686(2AA).

This is highly debatable. The fact that the Revenue cites no authority beyond "general tax law principles" should make us instantly suspicious. They appear not to have read *Carver v Duncan* to the end. For in the antepenultimate paragraph of his speech Lord Templeman says, in the context of grossing up of trust expenses which are allowable:

> "Thus, if trustees are entitled to gross dividends of £1,000 and receive after deduction at the basic rate of 30 per cent, the net sum of £700 which they apply in discharging rates, casual repairs or other outgoings which constitute income expenses amounting to £700, the trustees may deduct £1,000 from their total gross income for the purpose of computing the amount of gross income liable to tax at the additional rate."[12]

I myself see no reason why taxes such as rates, council tax or value added tax (if otherwise irrecoverable) should not be deductible.

It may be, of course, that what the Revenue have in mind is not simply taxes but income taxes. Now even they admit that one grosses up deductible expenses, so that income tax on income used to defray such expenses is clearly deductible. See 4.4 of the Guidance.

The Revenue may mean nothing more than one in computing income chargeable at the RAT one does not deduct income tax at the ordinary rate on such income. I agree, but not because of "general tax law principles". Section 686(1) makes it clear that so far as income is income to which the section applies it is to be chargeable at the RAT instead of at the ordinary rate.[13] In ascertaining the quantum of the income chargeable at the RAT one clearly cannot deduct tax chargeable at the RAT on such income, as one first has to complete the exercise of ascertaining the quantum before one can calculate the amount of the tax.

What of income tax which is not charged at the RAT? Normally, of course, that will be a charge on the underlying income, so that no question of deducting it for section 686 purposes will arise. Where, however, the income on which the tax at the ordinary rate is charged is taxable income but not real income, the position is my view different. For example, if trustees have an excess of balancing charges over capital allowances, the excess is taxable but there is no real income corresponding to it. Because it is not real income, it is not taxable at the RAT.[14]

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12 Italics added by R.V.

13 The position was perhaps less clear in the days when section 686 charged tax at the additional rate, in addition to the basic rate.

14 It cannot be accumulated or payable at the discretion of any person.

Provided, as a matter of trust law, the tax on the unreal income is payable out of taxable income which is taxable at the RAT, it should in principle be deductible in computing the quantum of the income taxable at the RAT.

Summary - accumulation/discretionary trustees

4.21 In looking at TMEs for the purposes of taxing accumulation/discretionary trustees, it is necessary to consider

- *whether a particular cost is an expense at all, as opposed to e.g. a distribution*

- *if so, whether it is an expense of the trustees if so, whether it is 'properly chargeable to income', that is an income expense according to general trust law principles (and ignoring what the trust deed says)*

- *if so, whether it is also an expense for the purposes of Section 686(2AA)*

- *if so, whether it was defrayed (i.e. paid) in the tax year in question*

As already indicated, I would take issue with the last statement, but it may be in trustees' interests in certain cases to agree with it.

SECTION 5 PRINCIPLES of TMEs in IIP TRUSTS

TMEs and IIP trustees

5.1 Trustees of IIP trusts are chargeable at up to basic rate tax on trust income. The trustee does not get relief against dividend ordinary rate, savings rate or basic rate tax for any trust management expenses whatever. And unlike the trustees of accumulation/discretionary trusts, the trustees of IIP trusts are not normally chargeable to a higher rate, so there is generally no equivalent question of allowing TMEs against the RAT.

True.

5.2 However, there are certain situations where, because of specific legislation, the trustees of an IIP trust are chargeable at the special trust rates. These situations are where items that are capital in trust law are deemed to be income for tax purposes, and are also taxable at the special

> *trust rates. If the item is liable to tax at the special trust rates by virtue of being 'treated as income to which S686 applies', for example as in S686A(3) ICTA 1988 (company purchase of own shares) then the trustees are also entitled to relief for allowable TMEs under S686(2AA). If the deemed income is liable to tax at the 'rate applicable to trusts', for example S720(5) ICTA 1988, then there is no basis for relief under S686(2AA), as there is no connection with S686 itself. In practice, if the IIP trust incurs allowable TMEs, they will reduce the beneficiary's entitlement to trust income. It is unlikely that a receipt giving rise to a S686 charge would find its way into the hands of an IIP beneficiary, as it would not be trust income, only deemed income. So the fact that the trustees were liable to the special trust rates would most likely have no effect on the income beneficiary, and S686(2AA) TMEs would not come into question. So TMEs are not relevant to the taxation of IIP trustees.*

As a general statement, this cannot be faulted. What is most interesting is that the Revenue appear to consider that the only situations where the trustees of an IIP trust are chargeable at the special trust rates are where items that are capital in trust law are deemed to be income for tax purposes, and are also taxable at the special trust rates.

TMEs and IIP beneficiaries - introduction

5.3 TMEs are taken into account, among other items, in establishing the income of an IIP beneficiary for tax purposes. TMEs are only one consideration in measuring this income. What follows (in paragraphs 5.5 to 5.15) describes the whole process of arriving at the measure of the IIP beneficiary's income, and sets TMEs in that context.

5.4 As there is no general guidance on the taxation of IIP beneficiaries, this paper explains some aspects (in paragraphs 6.1 to 6.9). It sets out how tax paid by the trustees is taken into account, the basis of grossing up, and how trading expenses and capital allowances fit in.

IIP beneficiary's income

5.5 The income of an IIP beneficiary for tax purposes is the income arising to the trustees so far as he or she is entitled to it. That entitlement is the income of the trustees less any amounts to which such a beneficiary is not entitled.

This is ambiguously phrased. Is the Revenue talking of the income of the trustees for income tax purposes or for trust purposes? In my view, it is tolerably clear from the rest of the Guidance that they take the view that one first calculates the income of the trustees for income tax purposes and then asks to what extent the beneficiary is entitled to that income as a matter of trust law. It is only to that extent that the beneficiary has taxable income.[15]

This has two important corollaries. The first is that if there is in reality no income corresponding to that which is treated as income of the trustees for income tax purposes, the beneficiary cannot be taxable on it. (Nor, in the absence of an express provision, will the income of the trustees be caught by section 686 or taxed at the RAT.)

The second is that if the actual income of the trust to which the beneficiary is entitled is greater than the trustees' taxable income, the beneficiary cannot be taxed on the excess.

The importance of these corollaries can be shown in the context of capital allowances and balancing charges. If in Year 1 the trustees acquire an asset which entitles them to capital allowances which reduce the trust taxable income to zero, neither the trustees nor the beneficiary will be taxable in respect of trust income in that year, notwithstanding that there is real income for trust purposes to which the beneficiary is entitled. If in Year 2, the trustees dispose of the asset and incur a balancing charge, they are indeed taxable in respect of it, probably at the rate of 22%, but the beneficiary is not. Thus while the acquisition and disposal of the asset may have been tax-neutral from the point of view of the total taxable income of the trustees over the two years, it has had a benign effect on the total taxable income of the beneficiary over those two years.

5.6 The beneficiary is not entitled to the following so they are taken out of the reckoning for the IIP beneficiary's income entitlement and consequently his or her tax liability:

- *charges properly met by the trustees out of income, e.g. annuities*

- *income that the deed directs is to be applied for specific purposes, e.g. the redemption of a lease or mortgage*

- *trust management expenses properly chargeable to income*

While this is true, it does raise two independent points. First, as regards annuities charged on the trust fund, I am reminded of the miser in one of Miss Austen's novels who complains that when your estate is charged with annuities, your

15 See in particular sections 6.9 and 6.9A of the Guidance.

income is not your own. If annuities are payable by the trustees out of trust income, I myself would hesitate to say that the beneficiary had an interest in possession in the whole of the trust fund. Indeed, it is clear for inheritance tax purposes that he would not. However, that does not affect the income tax treatment of the beneficiaries.

Secondly, I have often wondered whether income which a trust instrument directs to be applied for specific purposes such as the redemption of a lease or mortgage might not be caught by section 686. Where its economic effect is tantamount to an accumulation of income, it would make sense if it were caught by the section. The same question arises in relation to trust expenses which under the general law would be chargeable to capital but which under the governing trust instrument are chargeable to income.[16]

IIP beneficiary's income - TMEs

5.7 There is no statutory provision for reducing the IIP beneficiary's measure of income for tax purposes by TMEs. There is, however, case law in Murray v CIR (11 TC 133), MacFarlane v CIR (14 TC 540), and CIR v Dewar (16 TC 93-94). Also, Section 689A (2), which deals with the disregard of expenses specifically where the beneficiary is non-resident, refers to expenses being 'disregarded in computing the income of the beneficiary for the purposes of the Income Tax Acts'.

I discuss section 690A under 5.8 below.

5.8 TMEs are not a tax deduction for IIP beneficiaries. IIP beneficiaries are not taxable on income used for TMEs, not because they get 'tax relief' on those expenses, but because they are taxed only on what they are entitled to - and the income out of which trust management expenses are paid is not income to which IIP beneficiaries are entitled (see CIR v Hamilton of Dalzell). Income that is used by the trustees to defray expenses properly chargeable to income is therefore disregarded in measuring the IIP beneficiary's entitlement. It follows that if the trustees pay expenses out of income that are not properly chargeable to income then the IIP beneficiary is taxable on that amount of income, even though he or she does not receive it.

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16 A quite separate question is whether such a provision in the trust instrument can prevent what would otherwise be an interest in possession from subsisting in the whole of the settled property. That is a question highly material to inheritance tax, which has always concerned me as a matter of theory but on which the Capital Taxes Office appear to be quite relaxed.

The main part of this section is correct. It does not follow, however, that if "the trustees pay expenses out of income that are not properly chargeable to income then the IIP beneficiary is taxable on that amount of income, even though he or she does not receive it." The Revenue would have to show further either that receivability rather than receipt of income was enough to make the beneficiary taxable or that, if receipt were required, receipt by the trustees, rather than by the beneficiary, was enough. They have cited no authority for either proposition. The question is part of a larger one: suppose that trustees receive income to which a beneficiary is beneficially entitled but through a breach of trust he never receives it. Is the beneficiary still taxable on that income? It would be hard indeed if he were.

Taxes Act 1988 section 690A is a most peculiar section. Quite probably, it has no effect at all, at least unless the facts are highly exceptional. One might speculate as to what the draughtsman thought he was trying to achieve. My own guess is that he was not as knowledgeable as the author of the Guidance and thought that trust expenses are deductible in computing the income of the beneficiary for income tax purposes and he wished to make it clear that they should be set off rateably against taxable and non-taxable income of the beneficiary.

Section 689A (Disregard of expenses where beneficiary non-resident) provides:

> "(1) This section applies where–
>
> > (a) there is income ("the distributed income") arising to trustees in any year of assessment which (before being distributed) is income of a person ("the beneficiary") other than the trustees;
> >
> > (b) the trustees have any expenses in that year ("the management expenses") which are properly chargeable to that income or would be so chargeable but for any express provisions of the trust; and
> >
> > (c) the beneficiary is not liable to income tax on an amount of the distributed income ("the untaxed income") by reason wholly or partly of-
> >
> > > (i) his not having been resident in the United Kingdom, or
> > >
> > > (ii) his being deemed under any arrangements under section 788, or any arrangements having effect by

virtue of that section, to have been resident in a territory outside the United Kingdom.

(2) Where this section applies, there shall be disregarded in computing the income of the beneficiary for the purposes of the Income Tax Acts such part of the management expenses as bears the same proportion to all those expenses as the untaxed income bears to the distributed income.

(3) For the purpose of computing the proportion mentioned in subsection (2) above, the amounts of the distributed income and of the untaxed income shall not, in either case, include so much (if any) of the income as is equal to the amount of income tax, or of any foreign tax, chargeable on the trustees (by way of deduction or otherwise) in respect of that income.

…"

Now if the draughtsman had known the first thing about the income taxation of trusts, he would have appreciated that income which is properly applicable to defraying trust expenses is simply not income of the beneficiary, within the meaning of section 689A(1). It is not taken into account in computing the income of the beneficiary for the purposes of the Income Tax Acts, within the meaning of section 689A(3) and therefore it is otiose for section 689A(2) to require part of it to be disregarded for that purpose.

5.9 TMEs reduce the measure of the IIP beneficiary's income if they are properly chargeable to income. If the trustees pay as TMEs items that are properly chargeable to capital, those amounts do not reduce the beneficiary's entitlement and consequently they do not reduce the measure of the beneficiary's income for tax purposes.

5.10 So, while an IIP beneficiary's income is reduced by allowable TMEs, conversely it is possible for an IIP beneficiary to be taxable on income they have not received where it has been used to pay an expense that is not properly chargeable to income.

See my comment under section 5.8

Properly chargeable to income

5.11 *'Properly chargeable to income' in the IIP trust context means properly chargeable to income under all four sources of trust law referred to above. By contrast with discretionary trusts, where Section 686 specifically excludes provisions in the trust deed, this term for IIP beneficiaries includes expenses whose final incidence falls on income by virtue of the terms of the trust deed.*

5.12 *So if a trust deed allows the trustees to pay what are normally capital expenses out of income, those expenses reduce the measure of the beneficiary's income. If a trust deed allows trustees to pay what are in general trust law income expenses out of capital, again the trust deed has priority over general trust law. Consequently the IIP beneficiary's income is not reduced by such expenses.*

Agreed. I would only add that if, in breach of trust, the trustees pay income expenses out of capital, that cannot augment the income to which the beneficiary is in fact entitled or his income for income tax purposes.

Basis of allowance

5.13 *Unlike for discretionary/accumulation trustees, there is no statute setting out the basis of allowance. As the beneficiary is taxable on income to which he is entitled as that income arises, it follows that TMEs should be allowed on 'incurred' basis rather than when paid. So the beneficiary's entitlement is income arising less allowable TMEs incurred.*

The statement that "the beneficiary is taxable on income to which he is entitled as that income arises" begs a very important question. It is well established that in many cases receivability without receipt does not give rise to any tax liability even where an individual is absolutely entitled to the source of the income. The case of income received by trustees but not by the beneficiary is even more complex. See my comment on 5.8 above.

I agree that TMEs should be allowed on an 'incurred' basis rather than when paid, but that is because the beneficiary is never even beneficially entitled to income which the trustees may properly consume in meeting trust expenses.

5.14 *In a year where allowable TMEs incurred exceed income arising the beneficiary's income entitlement will be nil. The excess allowable TMEs will be taken into account when paid. For example, in year 1 the trust income arising is £2,000, allowable TMEs incurred £2500. In year 1 the* *beneficiary's income entitlement is nil. In year 2, the trust income is £2,000, allowable TMEs incurred nil, and the trustees pay the £2,500 incurred the previous year. The beneficiary's entitlement is income arising £2,000 less TMEs incurred nil year 2 less £500 brought forward from year 1, i.e. £1,500.*

It seems to me that the position is rather more complex and depends on the underlying trust treatment. If, indeed, in year 2 the trustees are entitled to deduct £500 from what would have otherwise have been the beneficiary's actual income, then the conclusion stated would follow. But if they are not, I do not see how it could.

Order of set-off of TMEs in IIP beneficiary's tax calculation.

5.15 S689B ICTA 1988 applies to both discretionary/accumulation trusts and IIP trusts. Consequently, the order of set-off of TMEs in an IIP beneficiary's tax calculation is the same as for accumulation/discretionary trustees. See para. 4.4.

5.16 The phrase 'or would be so chargeable but for any express provisions of the trust' in S689B(1) is intended to apply only to accumulation/discretionary trusts.

I seriously doubt whether section 689B was ever intended to have any application to interest in possession trusts. The comment in section 5.16 of the Guidance might have alerted the Revenue to that. Section 689B is brought into play by section 686(2AA) and makes sense only in the context of non-interest in possession trusts.

Suppose a trust fund to comprise two sub-funds, one a portfolio of shares in United Kingdom resident companies, the income of which consists entirely of dividends paid by such companies, and the other a trade for the purposes of which the trustees make large payments which are chargeable to income as a matter of trust law but which are not deductible in computing taxable profits of that trade. Now the beneficiary is beneficially entitled at the most only to the actual (net) profits of the trade. He is entitled only to the net amount of the dividends received minus management expenses attributable to those dividends. It seems to me that there is no question of section 689B operating to set expenses referable to the trading income against net income from dividends. That is, so far as the beneficiary is concerned, an exercise which does not need to be performed for income tax purposes.

Mandated income and TMEs

5.17 *The trustees may mandate trust income to a beneficiary. They exclude the income from the Trust and Estate Tax Return, even if it is untaxed. The beneficiary's trust income is a share of the net taxed income as calculated on normal basis, and the gross amount of untaxed income directly chargeable on him. The beneficiary includes the income on his personal return.*

While this statements perhaps represents a measure of practice, rather than of strict law,[17] no taxpayer is likely to quarrel with it.

5.18 *Where trustees mandate income and there are TMEs properly chargeable to income, such a beneficiary may reduce the income chargeable at higher rate only. This practice of charging such income at no higher than the basic rate necessarily follows from the case law propositions that there is no income tax relief at basic rate for income used to meet TMEs (see 3.2 and 3.3) although an IIP beneficiary receives income mandated to him, to the extent that it is used to meet expenses properly borne by income it is not a part of his entitlement (see 5.8)*

Whether the beneficiary would be technically liable to income tax at the ordinary rate on income which he received but to which he was not beneficially entitled is arguable. However, if he refused to pay, the Revenue might well have recourse against the trustees and it is most improbably that the Courts would hold that neither of them was liable.

Summary - IIP beneficiaries

5.19 *In taxing IIP beneficiaries it is not just TMEs that have to be taken into account, but also charges and income used for specific purposes.*

5.20 *In looking at TMEs for the purposes of taxing IIP beneficiaries, it is necessary to consider:*

- *whether a particular cost is an expense at all, as opposed to, for example, a distribution*
- *if so, whether it is 'properly chargeable to income', that is an income expense according to the provisions of the trust deed or to general trust law principles*

17 It may be based on a misunderstanding of *Williams v Singer* [1921] 1 AC 65.

- *if so, if it was incurred in the tax year.*

Even if a particular cost is a distribution then, unless is it made to the beneficiary entitled to the interest in possession,[18] it will still reduce both his taxable and his taxable income.

SECTION 6 IIP BENEFICIARIES - OTHER ASPECTS

Net and gross amount of entitlement for tax purposes

6.1 *Tax is charged on the beneficiary's entitlement. The beneficiary receives income net of tax and income expenses including TMEs (that receipt referred to below as 'the net amount'), but is actually entitled to the untaxed amount of the income, net of income expenses including TMEs (that entitlement referred to below as 'the gross amount').*

6.2 *So the net amount is grossed up at the appropriate tax rates to arrive at the amount included in the beneficiary's income for income tax purposes. This reflects that the beneficiary is entitled to the untaxed amount of the net income (i.e. the gross amount).*

If what the beneficiary receives is indeed income net of tax (see section 5.17), this is correct.

Tax paid by IIP trustees

6.3 *The income tax paid by the trustees on that part of the income used to defray the TMEs and other items excluded from the IIP beneficiary's entitlement is not part of the beneficiary's entitlement, because the income out of which the tax is paid is not part of the beneficiary's entitlement. But the rest of the tax paid by trustees represents income to which the IIP beneficiary is entitled.*

Agreed.

Tax credit for the IIP beneficiary

6.4 *The beneficiary is given credit for the tax already paid by the trustees (or deducted at source) on the amount included in the beneficiary's income for income tax purposes. That credit, i.e. tax already paid on the income to*

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18 If the trustees can lawfully make distributions to other beneficiaries, it seems to me that the beneficiary would not be entitled to an interest in possession at all.

which the beneficiary is entitled, will necessarily be represented by the difference between the gross amount and the net amount. [There then follows an example, with comment, at 6.5 - 6.7.]

This statement and the example are correct.

IIP beneficiaries of trust that trades or has rental income

Trading or rental business expenses

6.8 If the gross trust income is £10,000 and there is allowable trading or rental business expenses for tax purposes of £2,000, the trustees are taxable on the net profit of £8,000, as being in receipt of the net income. (Section 59 ICTA 1988 makes the trustees chargeable on receipt of trading income. Section 21 does the same for rental income.) The IIP beneficiary is entitled to the income of the trust (not to receipts). In this context the trust income is £8,000 not £10,000, so the measure of the beneficiary's income is £8,000.

Agreed, subject to two points. First, the relevant provisions in Taxes Act 1988 section 59 have been repealed by Income tax (Trading and other Income) Act 2005. Second, the beneficiary is entitled to a maximum of the net trading etc. income, before deduction of TMEs.

Trading or rental business Capital Allowances

6.9 If the net profit after allowable trading expenses is £8,000 and the trustees can claim £3,000 Capital Allowances for tax purposes, the beneficiary's measure of income for tax purposes is taken to be £5,000. Just as a credit for basic rate tax paid by the trustees is carried through to the beneficiary, so is the benefit of capital allowances in respect of qualifying expenditure.

Trading or rental business and losses

6.9A The position here is similar to that for Capital Allowances. If the trustees have trading or rental losses that they can use against trading or rental income in any year to reduce the trust's taxable income, the IIP beneficiary's taxable income for that year is consequently reduced.

These are most important statements, showing that the Revenue accept that the taxable income of the beneficiary can never be greater than that of the trustees and that he indirectly obtains the benefit of capital allowances.

SECTION 7 PRINCIPLES OF TMEs IN BARE TRUSTS

7.1 Where a bare trust exists, the beneficiary has an absolute right to trust capital and income as it arises. So the beneficiary's entitlement for tax purposes is the gross income of the trust before deduction of any expenses the trustees incur. The beneficiaries show the gross trust income on their personal returns. They must not deduct the expenses that the bare trustees pay, because the income used to pay those expenses is income that belongs to the beneficiary.

7.2 The general position is therefore that bare trusts do not have any allowable TMEs.

Agreed.

7.3 Exceptionally, the trustees may have, as a matter of statute law, a charge, lien or other right to resort to the assets (for example for the payment of estate duty, capital transfer tax, inheritance tax, capital gains tax etc.). If the trustees have a statutory lien over the funds held on bare trust, then because the fund cannot be said to be absolutely the beneficiary's, the position reverts to something like an IIP trust. While in a bare trust there is no concept of 'properly chargeable to income', where, as here, the trust becomes something like an IIP trust, those expenses which would be properly chargeable to income in an IIP trust will be treated as 'properly chargeable to income'. So for the purposes of higher rate tax, and only as long as the lien etc. exists, the expenses that the trustees incur, that are properly payable out of income reduce the income that the beneficiary declares.

Agreed in principle, subject to the caveat that if the trustees really did have such a charge or lien, the trust would not in my view be a bare trust.

SECTION 8 PRINCIPLES OF TMEs IN SETTLOR-INTERESTED TRUSTS

8.1 Income arising under a settlement where the settlor or settlor's spouse retains an interest is deemed to be the settlor's (Sections 619 - 628 ITTOIA). This applies to both accumulation/discretionary trusts and IIP trusts. The next two paragraphs explain how this affects TMEs in each type of trust.

8.2 *The settlor of a 'settlor-interested' accumulation/discretionary trust gets no relief for TMEs. 'Income arising under a settlement' in a settlor-interested trust is the gross income without the deduction for trust management expenses. In computing the settlor's liability the same deductions and reliefs are allowed as would be if the deemed income had actually been the settlor's. But no trust management expenses are allowed over and above the normal deductions for each source of income.*

8.3 *The settlor of a 'settlor-interested' IIP trust gets no relief for TMEs. Where the settlor is a beneficiary of an IIP trust, he or she is liable to tax in the normal way as an IIP beneficiary, on the income after the trustees have paid expenses properly chargeable to income. However, Section 624 ITTOIA 2005 deems all the income arising to the trustees to be the settlor's, so under Section 624 ITTOIA 2005 the settlor is also taxable on the income used to meet the trust management expenses. Inland Revenue help sheet IR270 explains this further.*

Agreed.

SECTION 9 TRUST MANAGEMENT EXPENSES - GUIDE TO SPECIFIC ITEMS

9.1 *The tax treatment of trust management expenses detailed below applies (provided that there is no Court order directing otherwise) to trustees of accumulation/discretionary trusts. IIP beneficiaries where there is no specific provision for the item, or giving the trustees general discretion as to incidence of expenses, in the trust deed.*

9.2 *Where appropriate, the guidance on specific items distinguishes between the treatment of trustees of accumulation/discretionary trusts and IIP beneficiaries where there is no relevant provision in the trust deed. Otherwise it applies to both situations.*

9.3 *Where there is a Court Order that specifies the incidence of an expense the terms of the Court order take preference over the treatment described below. For example, if a Court Order directs a capital expense to be charged to income, then it can be an allowable TME for tax purposes.*

This may be unduly favourable to taxpayers.

9.4 *In a few situations it is appropriate to consider apportioning what is, after applying the principle in paragraph 2.5, apparently an expense of capital, between income and capital. The governing principle here is that when* *what is procured for the trust can properly be said to be for the income fund as distinct from the capital fund, rather than the two matters being inextricably bound together, then apportionment is reasonable. For example, accounts are procured precisely so that the income position can be considered distinctly from the capital position, so it may be appropriate to apportion the expense. As a contrasting example, a secretary employed by the trust is extremely unlikely to undertake work distinctly to secure the income of the trust. The cost of a secretary is for the better administration of the trust as a whole, and so in this instance apportionment would not be appropriate.*

This is too broad a brush. Much depends on what is done and for what purpose.

Accountancy and audit costs

Cost of having trust accounts prepared

9.5 Where accountancy costs have already been allowed against trading income they will not come into consideration as TMEs. The trust can have relief for a particular expense only once.

Agreed.

9.6 Where there is no trade, as in most trusts, case law principles determine the allowance of TMEs (as set out in the Explanatory Note above). It can be argued that, since well-drawn trust accounts include balance sheets and capital accounts, they are to the benefit of the trust fund as a whole so that the cost of having them prepared should fall on capital. However, the nature of trust accounts is such that it is reasonable to accept that the costs of accounting for the trust's income should be treated as a distinct expense, and as such payable out of income.

In each trust therefore, a part of the costs of having trust accounts prepared will be properly chargeable to income, on the basis of a just and reasonable apportionment. Such an apportionment is best made by the person who prepares the accounts.

This is likely to be acceptable to most taxpayers.

Cost of having trust accounts audited

9.8 Section 22(4) Trustee Act 1925 empowers trustees to commission an audit of trust accounts in specified circumstances. If an audit is undertaken *pursuant to the Section 22(4) power then, by the same provision, trustees have discretion as to the final incidence of such expenses between income and capital. In such a case the trustees' exercise of their discretion will be taken as conclusive to determine the incidence of the expenses, and what the trustees charge to income will be allowed as a TME. If the trustees do not positively exercise their discretion then Section 22(4) provides, in effect, that the expenses associated with auditing capital are to be borne by capital, and those associated with auditing income to be borne by income. In such a case only the latter are allowable TMEs.*

Agreed.

9.9 In circumstances other than those envisaged by Section 22(4) Trustee Act 1925 Trustees may be empowered by the trust instrument to undertake audits. If the audit is undertaken pursuant to a power in the trust instrument the incidence of the expense of it is governed by general principles. Although an audit is undertaken for the good of the trust as a whole, some of the expenses of such an audit are allowable as TMEs on the basis of just and reasonable apportionment. Such an apportionment is best made by the person who carries out the audit.

This is one of the areas where there is a potential gap between what would be indicated (but was not decided) by the *Carver v Duncan* approach and current accounting practice.

Cost of preparing trust tax return

9.10 The expense of having a trust tax return prepared is more likely to be income than capital, because the trust returns income each year, but does not always make a chargeable disposal for CGT purposes. If only income is returned in one year all of the costs are allowable TMEs. If both income and capital gains are returned the allowable TMEs are those that relate to income, apportioned on a just and reasonable basis. This is most easily done by excluding the costs of preparing the capital gains part of the return.

This is reasonable.

Cost of obtaining tax advice

9.11 Where the tax advice relates to capital gains tax or IHT, the costs are not properly payable out of income, as they cannot be said to relate to income in any way. These costs are not allowable TMEs.

Agreed.

9.12 Tax advice is an allowable TME only where it relates directly to the preparation of income tax returns (see above).

This is far too sweeping. What of tax advice aimed at reducing the income tax liability of trustees and/or beneficiaries?

Bank charges and interest

9.13 Whether charges on a bank account or overdraft are payable out of income or capital depends on what those charges secure. If they secure a facility that is for the better administration of the trust fund as a whole, such charges should be treated as an expense of capital. So for example charges on a current account, whether or not it incidentally bears interest, or to keep open an overdraft facility that may or may not be taken up, are capital and so the charges are not TMEs properly chargeable to income. They are therefore not allowable TMEs.

This is another of the areas where there is a potential gap between what would be indicated (but was not decided) by the *Carver v Duncan* approach and current accounting practice.

9.14 Whether interest on a bank loan or overdraft is allowable depends on the actual use of the funds advanced by the bank to the trustees. See 'Interest' below at 9.21-9.23.

Depreciation

9.15 Depreciation is not in any sense income treated as applied in defraying the expenses of the trustees. Consequently it is not an allowable TME for S686(2AA) purposes. Depreciation cannot affect the income entitlement of an IIP beneficiary, and so is not an allowable TME for those purposes either.

I agree that depreciation is not relevant for section 686(2AA) purposes. However,

I am staggered at the statement that "Depreciation cannot affect the income entitlement of an IIP beneficiary".

Distributing income - cost of

9.16 The incidental costs of making distributions such as the cost of posting a cheque to a beneficiary are not properly chargeable to income because they are not concerned (solely or otherwise) with the securing the trust income (see above at 2.16). These costs are therefore not allowable TMEs.

This is based on a misconception. See my comment on section 2.11 above.

Insurance premiums for trust assets

9.17 If the premiums for insuring trust assets have been deducted from any trading or rental income of the trustees they do not fall to be considered as TMEs. The trust can have relief for a particular expense only once.

Agreed.

9.18 If, unusually, the trustees have insured trust assets outside of a trade, the premiums should generally be regarded as payable out of capital as a matter of trust law, because what is insured is trust capital. These costs are therefore generally not allowable TMEs.

The Revenue appear to be unaware of Trustee Act 1925 section 19!

9.19 As an exception to this, TMEs are allowable where:

- *the premiums relate to buildings insurance for a property; and*
- *the lease contains an obligation to insure the property; and*
- *the trustees are lessees of the property, and*
- *either that leasehold property is occupied by beneficiaries under the terms of the trust,*
- *or the property is generating rental income for the trust,*
- *and, in either case, neither the beneficiaries nor any tenants (as the case may be) are under a legal obligation to meet the insurance premium.*

If the property is generating rental income for the trust, it is difficult to see why the premium is not deductible in computing the income tax charge on the trustees at the basic rate.

If the property is occupied by beneficiaries under the terms of the trust, I cannot see why that fact should of itself make the premiums deductible.

9.20 *There may be cases where insurance premiums are payable in respect of trust property used or occupied by a beneficiary where the terms of the beneficiary's use or occupation include their being obliged to meet the insurance premium. In that case the payment of the insurance premiums by the trustees would be a distribution and not an expense at all, and so would not be an allowable TME.*

Correct. What is interesting is that the Revenue apparently consider that if the beneficiary were not obliged to meet the insurance premium, the payment would not be a distribution.

Interest

9.21 *Interest may have been incurred in the course of a trade or rental business and already allowed as a deduction against trading or rental income. As a separate matter, some interest may be incurred as a trust management expense.*

9.22 *In certain instances interest can be an allowable TME, where it is paid to secure the income of the trust. . As explained above in 2.11, by 'outgoing' is generally meant some payment which must be made in order to secure the income of the property. Where the funds are used so that what the payment of interest secures is purely for the benefit of the income fund, for example where interest is paid on a loan taken out in order to purchase an income-bearing asset for the trust, the interest should be regarded as an expense of income. Otherwise, interest is not properly chargeable to income and is therefore not an allowable TME. For example, if a loan is taken out or overdraft arranged to pay for general administration, or to buy a non-income generating asset for the trust, that is not an expense paid to secure the income of the trust, and the interest is not allowable.*

What confusion! For the Revenue's misconception as to the basic test, see my comment on section 2.11 above. If the Revenue were otherwise correct, the exception where a loan is taken out to purchase an income-bearing asset would not stack up, at least to the extent that the interest exceed income from the asset.

9.23 Allowable interest includes:

- *interest on a loan or overdraft to purchase an income-producing asset, such as shares*

- *interest on a loan or overdraft taken by trustees for acquiring property that is occupied by a beneficiary*

- *interest on unpaid/overdue tax*

In my view, it will be only exceptionally that interest should not be chargeable to income. If I were wrong, the Revenue's exceptions would be illogical.

9.24 Interest on unpaid inheritance tax (except where the delay is caused by the neglect of the trustees) is properly chargeable to income. It is therefore an allowable TME.

While I would agree with the general principle, I cannot see why it makes any difference if the delay is caused by the neglect of the trustees, unless and to the extent that they are personally liable to pay the interest.

9.25 Interest paid on loans to pay inheritance tax is accepted as properly chargeable to income, and so as an allowable TME.

I quite agree with the conclusion, but how do the Revenue square this with their basic stance?

9.26 Interest payable under Section 86 TMA 1970 (interest on overdue income tax and capital gains tax) (except where the delay is caused by the neglect of the trustees, is properly chargeable to income. It is therefore an allowable TME.

I agree.

9.27 By contrast, surcharges under S59C TMA 1970 and tax penalties are not allowable TMEs. Nor is interest on surcharges and penalties.

How is interest on surcharges under section 59C TMA 1970 and tax penalties distinguishable from other interest?

Investment advice

9.28 The cost of taking investment advice is chargeable to capital, and so not an allowable TME. (See Carver v Duncan.)

While this will usually be the case, the statement is too categoric.

Legal costs

9.29 The trust law text book Underhill & Hayton, Law relating to trusts and trustees says at page 535 'all costs incident to the administration and protection of the trust property, including legal proceedings, are borne by corpus, unless they relate exclusively to the tenant for life. The corpus must bear all costs, charges and expenses incurred for the benefit of the whole estate.'

9.30 At page 544, it says about 'general costs incident to administration', 'Legal expenses or investment advice incident to the administration of a trust almost exclusively fall on capital, unless the settlor has expressly provided for them, for they are for the benefit of all persons interested.'

9.31 So legal costs are not allowable TMEs, unless they relate exclusively to the IIP beneficiary.

Broadly speaking this must be correct, although it may be appropriate in some cases to apportion legal expenses e.g. where tax advice is obtained both as to the inheritance tax liability and the income tax liability of the trustees.

Personal expenses of beneficiary

9.32 A trustee may pay expenses that are the personal liability of a beneficiary. The personal expenses could be of any kind, but tend to be related to property. Cases of this kind may arise in connection with tenancies for life of real estate but they could also arise in an accumulation/discretionary trust.

9.33 For example, a beneficiary may occupy a property belonging to the trust. The trustees could pay items that are the occupier's responsibility, as opposed to the owner's (trustee's) responsibility. This might include gas, electricity and telephone bills, or Council tax (including business rate if appropriate).

9.34 *The amount used to settle such expenses is a distribution in kind to the beneficiary in question, and is treated as such and not as a trust management expense. Therefore personal expenses of the beneficiary are not allowable as TMEs for trustees of accumulation/discretionary trusts or beneficiaries of IIP trusts.*

Agreed.

9.35 *Such payment confers an income benefit on the beneficiary and creates a charge on the trustees, of such a gross sum as after deduction of tax at the basic rate leaves a net amount equal to the expenses paid*

9.36 *The trustees should give the beneficiary a form R185(Trust Income). The income benefit conferred on the beneficiary is an annual payment. The grossed up expenses can give rise to liability on the trustees under S348 ICTA 1988 - ITTOIA.*

The income benefit may or may not amount to an annual payment.

Premiums on life policies

9.37 *These are a capital expense, as established in Carver v Duncan, and so not allowable as TMEs.*

Carver v Duncan was concerned only with certain types of life policy.

Property costs

9.38 *Some payments related to property properly held for the occupation of a beneficiary can be categorised as income expenses, as opposed to an income benefit of the beneficiary (see 'Personal expenses'), and are allowable TMEs. These would usually be the costs of*

- *maintenance of a freehold property*
- *rent or maintenance costs of a leasehold property, paid by trustees pursuant to the terms of a lease of which they are the lessees*

where

- *the property is properly held by the trust for the occupation of a beneficiary and*

- *is actually occupied by a beneficiary, or the only reason it is not is because the property is in a state of disrepair that makes it uninhabitable and*

- *the beneficiary is not occupying on terms that he meets those expenses himself.*

This is in my view unduly favourable to taxpayers.

Reimbursement of expenses to trustees

9.39 *Where a trustee pays costs out of his or her own pocket, and is entitled to be reimbursed from trust funds, the trustee may take the reimbursement from either income or capital in the first instance. However, the final incidence of that expense is another matter: whether the amount is an allowable TME depends on the nature of the cost. Costs of reimbursement are allowable or not according to the general principles applying to the nature of the cost.*

Agreed.

Running costs

9.40 *Where - typically in larger trusts, such as those established by a business for the benefit of its current and former employees - the method of administration of the trust involves maintaining an office, the attendant expenses are not properly chargeable to income. Such expenses include salaries of personnel, expenses of accommodation, cleaning, and maintenance of equipment and premises. These are the expenses of the operation of the trust as a whole, and so properly chargeable to capital. The fact that such charges may be recurrent does not affect that fact that they are incurred for the benefit of the trust as a whole and hence capital. Furthermore such costs cannot be said to be made solely to secure the trust's income. They are therefore not allowable TMEs.*

Again, this is in my based on a misconception. See my commentary on section 2.11.

Travel and subsistence costs

9.41 *The incidence of travel and subsistence costs properly incurred by trustees depends on their purpose. Usual principles apply so that the matter turns on whether those expenses were incurred solely for the benefit of/in the* *course of securing the income of the trust. So, for example, expenses incurred in having meetings to decide which beneficiaries should be given income are not incurred for the benefit of/in the course of securing the income of the trust. They are incurred in the course of the distributive process. They do not result in an increase or maintenance of the income fund - or any part of trust funds. In fact they diminish trust funds. Therefore they are not properly chargeable to income, and are not allowable TMEs. In the vast majority of cases travel and subsistence expenses incurred by trustees will properly fall on capital.*

Again, this is in my based on a misconception. See my commentary on section 2.11.

Trustees' fees

9.42 The position on trustees' fees is widely disputed. The issue of trustees' fees is likely to be the subject of litigation between HMRC and other interested parties in the near future. HMRC's current position is as set out in paras. 9.43–9.44. Trust representatives' position is as set out in para. 9.45.

Trusts administered by the Public Trustee

9.43 The following position does not apply to cases administered by the Public Trustee. There is specific statute on the Public Trustee's remuneration. The current fees order is the Public Trustee (Fees) Order SI 1999 No. 855. That provides that all fees are payable out of capital except those specified in the Order. Only those costs specifically chargeable to income by statute are allowable TMEs.

All other trusts

9.44 Trustees' fees represent payment for work done by the trustee in carrying out the terms of the trust as a whole. Corporate trustees' brochures suggest that these fees are in fact charged to capital. The Law Commission paper 175, Capital and income in Trusts: classification and apportionment at para. 2.53 says about trustees' fees 'The irresistible conclusion is that the annual fee reflects work done on behalf of both income and capital. Since the work done is for the benefit of the whole estate the fee should be charged to capital...' On general principles, therefore, trustees' fees are properly payable out of capital.

Again, this is in my based on a misconception. See my commentary on section 2.11.

9.45 Trust representatives' have put forward the following arguments. Trustees' fees are annual recurrent expenses. The annual fee reflects work done on behalf of both income and capital. There is a case for apportioning the fees partly to income.

This seems to me to be an eminently sensible approach.