Management expenses

The taxation of trusts has been of continuing interest to tax practitioners. MALCOLM GUNN revisits the question of their management expenses.

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A short item on a students' page in the first issue of *Taxation* covered trust management expenses. It said simply that where the will or settlement deed does not expressly state that trust expenses should be applied against income to any extent, then income of the beneficiaries from the trust is their proportion of the income received before any such deductions are made.

I must confess that, had I been asked what the position was, I might have given a different answer. In my experience, there used to be a common practice of treating most recurring trust expenses as deductible from income. This was on the basis that no one, in general terms, should be living off their capital, and neither should trustees who should behave very conservatively. Therefore, the general annual expenses of running a trust should be charged to income, otherwise the capital could become depleted over the years. An exception could be made for expenses related specifically to capital, such as the sale of property, or to exceptional costs which would be a heavy burden on income, but otherwise it was quite usual to charge annual fees for running a trust against income.

As we shall see, things were turned on their head when an important case went to the Court of Appeal in 2008. Nowadays, the tax position depends on the type of trust involved. Starting with the more straightforward cases and then progressing to the less well-defined ones, the position is as follows.

Trusts generally: business income

Expenses relating to any trading income or property business income are not affected by the cases relating to trust management expenses. So expenses that relate wholly to the management of trade or property business income on ordinary principles will be deductible from that income.

KEY POINTS

- General principles underlying deduction of trust expenses.
- A summary of the position for different types of trust.
- The *Lord Chetwode* decision was that no trust management expenses are deductible from income taxed on the settlor.
- The STEP standard provisions.
- HMRC guidance and record-keeping advice.

Settlor interested trusts

Following the decision in *Lord Chetwode v CIR* [1977] STC 64, no trust management expenses are deductible from income that is taxed on the settlor. That case related to the transfer of assets abroad provisions as applied to the transferor, but it is accepted that the same principle also applies to UK trusts under which the income is taxed on the settlor.

The principle is that the expenses would not be allowable if the settlor had not created the trust or made the transfer overseas; consequently, they should not have a tax benefit if the income is taxed under anti-avoidance provisions.

Trusts with interest in possession

These trusts are covered specifically by ***ITA 2007, s 500***.

In essence, s 500 says that if the trust deed states specifically how expenses are to be applied (in other words, whether to capital or to income) that allocation applies for tax purposes, unless there is an overriding law that prevents it. However, if there is no specific allocation under the trust deed, general principles apply as to what may be charged to income. Those principles will be taken largely from the *Peter Clay* case, more on which on the following page.

It is not common for a trust deed to state how expenses are to be applied. The STEP standard provisions (tinyurl.com/y8ywo7cr) do not give any allocation of expenses although they contain a power in these terms:

> 'Income may be set aside and invested to answer any liabilities which in the opinion of the trustees ought to be borne out of income or to meet depreciation of the capital value of any trust property. In particular, income may be applied for a leasehold sinking fund policy.'

ITA 2007, S 500

Restrictions on use of trustees' expenses to reduce the beneficiary's income

(1) Expenses of the trustees can be used to reduce the beneficiary's income for income tax purposes only so far as:
   (a) the expenses are incurred by the trustees in the current tax year or in an earlier tax year; and
   (b) as a result of the expenses being chargeable to income as mentioned in subsection (2) or (3), the beneficiary's entitlement to the beneficiary's income is reduced by reference to the expenses.

(2) Expenses are chargeable to income for the purposes of subsection (1)(b) if they are chargeable to income by the trustees under a term of the settlement (subject to any overriding law which prevents the expenses from being so chargeable).

(3) Expenses are also chargeable to income for the purposes of subsection (1)(b) if they:
   (a) are not chargeable to income by the trustees under a term of the settlement; but
   (b) are chargeable to income by the trustees in accordance with any law (subject to any overriding term of the settlement which prevents the expenses from being so chargeable).

(4) Expenses cannot be used to reduce the beneficiary's income for income tax purposes so far as they are expenses which have fallen, or may fall, to be taken into account for the purpose of calculating the trustees' liability to income tax for any tax year.

If the trustees decide that income should bear an expense under the above provision, then that allocation may follow for tax purposes, but I would not expect HMRC to meekly accept all decisions of the trustees as to what is to be paid from income.

In practical terms, s 500 means that an interest in possession beneficiary will be taxed on their entitlement from the trust, so this is a sensible result. It would not be a happy situation if a beneficiary was taxed on a particular amount of income but his actual entitlement was something less due to deduction of expenses.

Of course, trust expenses are not allowable against the income when considering the charge to basic rate tax. A deduction against income is only for the purposes of calculating the beneficiary's own tax position in relation to any higher rate tax due or any tax at source that may be recoverable.

Discretionary trusts

Discretionary trustees can claim their expenses chargeable to income against the trust rate of tax. For this purpose the rule is that the express terms of the settlement on the allocation of expenses must be ignored. Only expenses properly chargeable to income may be deducted (see ITA 2007, s 484).

How one decides the division of expenses between capital and income was the subject of the appeal in *CRC v Trustees of Peter Clay Discretionary Trust* [2009] STC 469. The Court of Appeal largely upheld HMRC's view, which was that only those expenses that related specifically to income matters could be charged to income. This therefore covers collecting and distributing the income, dealing with income tax returns and payments, and general correspondence with income beneficiaries.

Expenses that related to the management of the trust as a whole could not be charged to income and must be charged to capital. On HMRC's view, therefore, items such as annual investment management fees should not be charged to income because those charges relate to the management of the portfolio for the benefit of all beneficiaries. This came as something of a shock to those of us who held the view that no one should live on their capital, least of all trustees.

Allocating the expenses

In most trusts, the management of the income is not time-consuming and the fees largely relate to running the trust as a whole, so the *Peter Clay* decision means that most trust expenses must be applied to capital. That entails keeping some capital cash in hand. However, the Court of Appeal did allow an apportionment of expenses if it could be shown that a proportion of the whole fee charged related to income matters. This was a small success against HMRC's view, which was that only expenses that related wholly and exclusively to income could be attributed to that income.

Theory and practice

That is the theory but it is not so easy to put into practice. HMRC set out some detailed guidance in its *Trusts, Settlements and Estates Manual* at paragraphs TSEM8164 to TSEM8166 (tinyurl.com/ybztdyu9). This suggests that advisers charging on a time basis should keep records of the hours spent exclusively on income. Not many do!

HMRC goes on to say that trustees 'should have explained to accountants etc what constitutes activities exclusively for the income beneficiaries (by giving them a current copy of *Help Sheet HS392*)'. I am sure many accountancy firms will greatly appreciate having tax advice given to them by their clients. The guidance does accept that where no detailed time records are maintained, trustees can make their own apportionment between capital and income by reference to a review of the work involved over the year.

Conclusion

In some ways, the editor's rather conservative statement in the first issue of *Taxation* was 90 years ahead of its time! Section 500 contains a similar theme for interest in possession trusts, although it is slightly more generous than the first editor of this august publication in that it does allow some attribution of expenses to income on general principles. ■

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