AN ANALYSIS OF THE STRUCTURE

OF THE

INCOME TAXATION OF TRUSTS

by

MICHAEL K. ROBSON

A thesis submitted for the degree of Master of Laws in the Faculty of Law, Department of Taxation of the University of Glasgow.

October, 1981

AN ANALYSIS OF THE STRUCTURE OF THE INCOME TAXATION OF TRUSTS

Synopsis

By reason of its nature as a legal concept, the trust is destined to fit awkwardly within any statutory system of taxation. It is intended in this dissertation to present an analysis of the present structure of the income taxation of trusts, noting certain aspects of the role of the trust in income tax planning.

For ease of presentation, the work is divided into three parts.

Part 1 is primarily concerned with the rudiments of the income taxation of the trust. In particular, there is presented an examination of the means by which the schedular system is adapted for the purposes of trust taxation. The basis of the liability to tax of both the trustee and beneficiary is discussed; considerable attention being focused on the nature of the beneficiary's interest under a trust as the factor determing the Schedule by virtue of which the beneficiary is chargeable to tax.

Also comprised in Part 1 is an examination of the machinery provided by sections 16 and 17, Finance Act 1973 for the taxation of discretionary and accumulation trusts.

The discussion in Part 1 relates exclusively to the taxation of the trustee and beneficiary. However, Part 2 is concerned with the taxation of the truster and comprises an analysis of the operation of the anti-avoidance provisions of Part XVI, Income and Corporation Taxes Act 1970, as they apply to the trust concept.

In order to ascertain the scope of Part XVI consideration is given to the interpretation of the terms 'settlement' and 'settlor' as used therein. By virtue of the provisions of Part XVI the opportunity for the avoidance of income tax by means of the trust is severely limited. This limitation is achieved in general by the prescribing of circumstances in which the various flows of income (and to a certain extent, capital) associated with the trust may be redirected to and treated as the income of the truster. The discussion is on a practical level, although the theoretical disharmony between certain sections of Part XVI is considered.

It is demonstrated in Part 2 that the only trusts which may be utilized effectively for the purpose of avoiding income tax are settlements of capital. For the sake of completeness, in Part 3 there is provided a general description of the capital gains and transfer tax treatment of the trust.

Because of the enormity of the subject of trust income taxation, it has been necessary to restrict the scope of this analysis as far as possible to a consideration of the taxation of trusts resident and domiciled in the United Kingdom.

The law stated is as at 1st June, 1981.

CONTENTS

List of Cases

Aiken v. Macdonald's Trustees	(1894) 3 T.C. 306.
Allen v. M'Combie's Trustees	1909S.C. 710.
Ang v. Parrish	[1980]S.T.C. 341.
Archer-Shee v. Garland	(1931) 15 T.C. 693.
Attorney-General v. Power	[1906] 2 I.R. 272.
Baker v. Archer-Shee	(1927) 11 T.C. 749
Ball v. National & Grindlays Bank Ltd	(1971) 47 T.C. 287
Bank of Scotland v. Liquididators of Hutchinson & Main & Co. Ltd	1914 S.C. (H.L.) 1.
Barr's Trustees v. I.R.C.	(1943) 25 T.C. 72.
Berry v. Warnett	[1980]S.T.C. 631.
Bonesteel v. Bonesteel	(1872) 30 Wisc. 516.
Booth v. Ellard	[1980]S.T.C. 555.
Bowen v. Hall	(1881) 6 Q.B.D. 333.
Bray v. Ford	[1896] A.C. 44.
Brodie's Will Trustees v. I.R.C.	(1933) 17 T.C. 432.
Brotherton v. I.R.C.	[1978] S.T.C. 201.
Bulmer v. I.R.C.	(1966) 44 T.C. 1.
Carmichael v. Carmichael's Exrx	1920 S.C. (H.L.) 195.
Chamberlain v. I.R.C.	(1943) 25 T.C. 317.
Chinn v. Collins	[1981] S.T.C. 1.
Coathew Investments Ltd. v. I.R.C.	(1966) 43 T.C. 301.
Copeman v. Coleman.	(1939) 22 T.C. 594.
Corbett v. I.R.C.	(1937) 21 T.C. 449.
Cornwell v. Barry	(1955) 36 T.C. 268.
Cowley v. I.R.C.	[1899] A.C. 198.
Croskery v. Gilmour's Trustees.	(1890) 17R. 697.
Crossland v. Hawkins	(1961) 39 T.C. 493.
Crowe v. Appleby	(1976) 51 T.C. 457.
Cunard's Trustees v. I.R.C.	(1945) 27 T.C. 122.
Cunliffe Brook & Co. v. Blackburn	(1945) 27 T.C. 122.
Benefit Society	(1884) 9 A.C. 857.
D'Abrue v. I.R.C.	(1978) 52 T.C. 352.
D'Ambrumenil v. I.R.C.	(1940) 23 T.C. 440.
Dewar v. I.R.C.	(1935) 19 T.C. 561.
Dunderdale's Trustees v. I.R.C.	1936 S.C. (H.L.) 20.

Dunlop Pneumatic Tyre Co. Ltd. v. Selfridge & Co. Ltd.	[1915] A.C. 847.
Dunmore v. McGowan	[1978] S.T.C. 217.
Drummond v. Collins.	(1915) 6 T.C. 525.
Edwardes Jones v. Dawn	(1936) 20 T.C. 279.
Eilbeck v. Rawlings	[1981] S.T.C. 174
Fry v. Sheils' Trustees	(1914) 6 T.C. 583.
G's Trustees v. G	1936 S.C. 837.
Gartside v. I.R.C.	[1968] A.C. 553.
Giddings v. Eastman	(N.Y. 1835) 5 Paige Ch.56
Glyn v. I.R.C.	(1948) 30 T.C. 321.
Gosling v. Gosling	(1859) 70 Eng. Rep. 423.
Hamilton-Russell's Executor v. I.R.C..	(1943) 25 T.C. 200.
Hannay's Executors v. I.R.C.	(1956) 37 T.C. 217.
Hart v. Briscoe	(1977) 52 T.C. 53.
Harthan v. Mason	[1980] S.T.C. 94.
Heritable Reversionary Co. Ltd. v. Millar	(1892) 19R. (H.L.) 43.
Hoare Trustees v. Gardner	(1977) 52 T.C. 53.
Hood Barrs v. I.R.C.	(1946) 27 T.C. 200.
Income Tax Special Purposes Commissioners v. Pemsel	(1891) 3 T.C. 53.
Inglewood v. I.R.C.	[1981] S.T.C. 318.
I.R.C. v. Bates	(1966) 44 T.C. 225.
I.R.C. v. Bernstein	(1961) 39 T.C. 391.
I.R.C. v. Black	(1940) 23 T.C. 715.
I.R.C. v. Blackwell	(1924) 10 T.C. 235.
I.R.C. v. Buchanan.	(1957) 37 T.C. 365.
I.R.C. v. Clarkson-Webb	(1937) 17 T.C. 451.
I.R.C. v. Clark's Trustees	1939 S.C. 11.
I.R.C. v. Cookson	[1977] S.T.C. 140.
I.R.C. v. Delamere	(1939) 22 T.C. 25.
I.R.C. v. De Vigier	(1964) 42 T.C. 24.
I.R.C. v. Fitte	(1943) 25 T.C. 337.
I.R.C. v. Glenconner	(1941) 24 T.C. 82.
I.R.C. v. Kenmare	(1957) 37 T.C. 383.
I.R.C. v. Leiner	(1964) 41 T.C. 589.
I.R.C. v. Morton	(1941) 24 T.C. 259.
I.R.C. v. Nicolson.	(1953) 34 T.C. 354.

I.R.C. v. Pay	(1955) 36 T.C. 109.
I.R.C. v. Payne	(1940) 23 T.C. 610.
I.R.C. v. Plummer.	[1979] S.T.C. 793.
I.R.C. v. Prince-Smith	(1943) 25 T.C. 84.
I.R.C. v. Rainsford-Hannay	(1941) 24 T.C. 273.
I.R.C. v. Regent Trust Co.	[1980] S.T.C. 140.
I.R.C. v. Tennant	(1942) 24 T.C. 215.
I.R.C. v. Trustees of the Hostel of St. Luke, Registered	(1930) 15 T.C. 682.
I.R.C. v. Wachtel.	(1970) 46 T.C. 543.
Jamieson v. I.R.C.	(1963) 41 T.C. 43.
Jenkins v. I.R.C..	(1944) 26 T.C. 265.
Kelly v. Rogers	(1935) 19 T.C. 692.
Kidson v. Macdonald	(1973) 49 T.C. 503.
Lees v. Nuttall	(1834) 39 Eng. Rep. 1157.
Lindus and Hortin v. I.R.C.	(1933) 17 T.C. 442.
Longfield Parish Council v. Robson	(1913) 29 T.L.R. 357.
Lord Advocate v. Gunnings	1907 S.C. 800.
Lumley v. Guy	(1853) 118 Eng. Rep. 749.
Macfarlane v. I.R.C.	(1929) 14 T.C. 532.
McCrone v. I.R.C..	(1967) 44 T.C. 142.
McPhail v. Dalton.	[1970] 2 All E.R. 228.
Miller's Trustees v. Miller	(1890) 18R. 301.
Mills v. I.R.C.	(1974) 49 T.C. 367.
Mitchell and Eadon v. Ross	(1961) 40 T.C. 56.
Monro's Trustees v. Monson	1965 S.C. 84.
Moss' Empires, Ltd. v. I.R.C..	(1937) 21 T.C. 264.
M'Phearson's Trustees v. Watt.	(1977) 5R. (H.L.) 9.
Muir v. I.R.C.	(1966) 43 T.C. 367.
Muir v. Muir	[1943] A.C. 468.
Murray v. I.R.C.	(1926) 11 T.C. 133.
Nelson v. Adamson.	[1941] 2 K.B. 12.
Parker v. Lord Advocate.	1960 S.C. (H.L.) 29.
Parker v. McKenna.	(1874) 10 Ch. App. Cas. 96
Partington v. Attorney-General	(1896) L.R. 4 H.L. 100.
Pearson v. I.R.C.	[1980] S.T.C. 318.
Pexton v. Bell	(1976) 51 T.C. 457.
re Pilkington's Will Trustees.	[1964] A.C. 612.
Potts' Executors v. I.R.C.	(1950) 32 T.C. 211.

Ramsey (W.T.) v. I.R.C.	[1981] S.T.C. 174.
Redfearn v. Somervail & C.	(1813) 3 Eng. Rep 618.
Reid's Trustees v. I.R.C..	(1929) 14 T.C. 512.
Roberts v. Hanks	(1926) 10 T.C. 351.
Roome v. Edwards	[1981] S.T.C. 96.
Saunders v. I.R.C.	(1957) 37 T.C. 416.
Saunders v. Vautier.	(1841) 49 Eng. Rep. 282.
Schalit v. Nadler	[1933] 2 K.B. 79.
Smith v. Smith	[1923] P. 191.
Smith & Snipes Hall Farm LD. v. River Douglas Catchment Board	[1949] 2 K.B. 500
Stanley v. I.R.C.	(1944) 26 T.C. 12.
Stephenson v. Barclays Bank Trust Co.	(1974) 50 T.C. 374.
Syme v. Commissioner of Taxes	[1914] A.C. 1013.
Taylor v. I.R.C.	(1946) 27 T.C. 93.
Thomas v. I.R.C.	[1981] S.T.C. 382.
Thomas v. Marshall	(1953) 34 T.C. 178.
Tomlinson v. Glyns Executor and Trustee Co.	(1969) 45 T.C. 600.
Vandervell v. I.R.C.	(1966) 43 T.C. 519.
re Vandervell's Trusts (No. 2).	[1974] 1 All E.R. 47.
Vestey's Executors v. I.R.C.	(1949) 31 T.C. 1.
Von Ernst Et Cie S.A. v. I.R.C.	[1980] S.T.C. 111.
White v. Whitcher	(1927) 13 T.C. 202.
Whitworth Park Coal, Ltd. v. I.R.C..	(1959) 38 T.C. 531.
Williams v. Barton	[1927] 2 Ch. 9.
Williams v. Singer	(1920) 7 T.C. 387.
Wolfson v. I.R.C.	(1949) 31 T.C. 141.
Woodehouse v. I.R.C.	(1936) 20 T.C. 673.

Abbreviations

Dymond	Dymond's Capital Transfer Tax
Foster	Foster's Capital Taxes
Hayton and Tiley	Capital Transfer Tax, 2nd Ed.
I.C.T.A.	Income and Corporation Taxes Act 1970
McCutcheon	Planning for Capital Transfer Tax: A New Approach
Simon	Simon's Taxes, 3rd Ed.
Tiley	Revenue Law, 2nd Ed.
Whiteman and Wheatcroft (in Parts 1 and 2) . . .	Whiteman and Wheatcroft on Income Tax, 2nd Ed.
Whiteman and Wheatcroft (in Part 3)	Capital Gains Tax, 3rd Ed.
Wilson and Duncan . . .	Trusts, Trustees and Executors

PART 1

THE LIABILITY TO TAX OF THE TRUSTEE AND BENEFICIARY

Introduction

The income tax legislation provides no code for adapting the schedular system for the purposes of trust taxation. The theoretical basis of the liability to tax of either trustee or beneficiary must, therefore, be found within the existing schedular framework.

Liability to tax can be created by Act of Parliament alone:[1] while it is open to the courts to interpret legislation, they are not, in theory, in the position to impose or absolve liability contrary to the intention of Parliament as expressed in the taxing statutes. According to Lord Cairns;

> "If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."[2]

Thus, if the income of either trustee or beneficiary is not derived from any source designated in the Schedules it cannot be assessed to tax. Further, if the income is assessable it must be charged only under the Schedule appropriate to its source:

> "Before you can assess a profit to tax you must be sure that you have properly identified its source or other description according to the correct Schedule; but once you have done that, it is obligatory that it should be charged, if at all, under that Schedule and strictly in accordance with the Rules that are there laid down for assessment under it."[3]

1. Halsbury's Laws of England, 4th. ed., vol. 8 para. 913.
2. Partington v. Att-Gen., (1869) L.R. 4 H.L. 100, at p. 122. Cf. the judgements of Lord Wilberforce and Lord Fraser of Tullybelton in W. T. Ramsey v. I.R.C. and Eilbeck v. Rawlings, [1981] S.T.C. 174.
3. Mitchell and Edon v. Ross, (1961) 40 T.C. 56, at p. 61 (per Lord Radcliffe).

It is with these somewhat inflexible principles that the theory of trust taxation must accord.

It is suggested in the Report of the Meade Committee that there are only two possible methods of taxing trusts:

> "(i) taxing the trust itself as a separate entity ... ; and
> (ii) taxing by reference to the circumstances of the beneficiary as if the trust did not exist ... "[1]

Trusts in which there is a fixed interest in possession are taxed by method (ii).[2] Although the Committee grossly over-simplifies the matter, the basic theory is that the various taxing provisions are applied to the parties to the trust, and the trust itself is, by and large, ignored.

Trusts in which there is no fixed interest in possession (discretionary and accumulation trusts) are essentially taxed by method (i).[3] The trust is recognised as an entity; there is provided a separate machinery for the taxation of payments from the trust although this does not affect the basis of the liability of the trustee and beneficiary under the Schedules.

In this part consideration is given first to trusts in which there is a fixed interest in possession. An outline of the trust concept is provided in Appendix 1.

1. "The Structure and Reform of Direct Taxation", at p. 401.
2. Ibid., at p. 404.
3. Ibid., at p. 404.

TRUSTS IN WHICH THERE IS A FIXED INTEREST IN POSSESSION

Since a trust in which there is a fixed interest in possession[1] is not recognised as a taxable entity, the liability to tax of the trustee and that of the beneficiary must be considered separately.

TAXATION OF THE TRUSTEE

A) The status of the trustee

Trustees are 'persons' for the purposes of the Income Tax Acts; however, they are distinct from the persons who may from time to time be trustees. Thus a trustee's personal income is ignored in computing his liability to tax as a trustee; likewise, the trust income is left out of account in computing the trustee's personal liability to tax.[2] The principle is tacitly recognised in s. 154(7), I.C.T.A. which provides that a change in the trustees of any trust is not to be treated as a change in the persons engaged in any trade or profession carried on by those trustees as such.

Although trustees are persons for tax purposes they are not 'individuals' Actual authority for this proposition is scant. Viscount Sumner in Baker v. Archer-Shee noted:

> "Super tax is chargeable in respect of the income of an 'individual' from all sources. Even in the easiest case of a trustee to accumulate income, no one would say that his trust was a 'source of income' to him as an 'individual', for in the case of several trustees they are not 'an individual' at all."[3]

In consequence, trustees are not entitled to the personal reliefs which by virtue of s. 5, I.C.T.A. may be claimed only by individuals: neither are they assessable to tax at the higher rates applicable to individuals by virtue of s. 32(1)(b), Finance Act 1971. As to the addition rate of tax, Vaines noted:

1. The meaning of an interest 'in possession' is discussed in Part 3 below at p. 199-205.
2. Tiley, at 17:10.
3. (1927) 11 T.C. 749, at p. 767 (dissenting). Cf. Farrand (1977 Conv. 5) who observed that references to 'an individual' in a statute should cover cases where there is more than one trustee, for 'in every Act ... unless the contrary intention appear ... words in the singular shall include the plural' - s. 1(1)(b), Interpretation Act 1889. However, further support for the proposition that trustees are not 'individuals' may be gleaned from the judgements of Lord Skerrington and Lord Johnston in Fry v. Sheils' Trustees, (1914) 6 T.C. 583.

> "The enactment of section 16 of the Finance Act 1973 was apparently required specifically to empower the Revenue to assess trustees to the additional rate; the surcharge, being payable by individuals only, would otherwise not have applied to trustees."[1]

B) The basis of the trustee's liability to tax

Unless the trust instrument otherwise provides, trustees are not allowed to retain any of the trust income for their own benefit. Their liability to tax is generally attributed to the fact that they are persons who receive or are entitled to income and it is of no consequence that their entitlement is not of a beneficial nature.[2] Although it is convenient to describe the basis of the trustees's liability to tax on trust income in terms of 'receipt', 'receivability' or 'entitlement' it must be emphasised that liability can attach to a trustee only if it is shown that the income to which he is entitled falls within one of the Schedules mentioned in s. 1,I.C.T.A.

Trustees are the persons in control of trust income and it is they who are entitled to sue for any income due from the trust's source;[3] their role cannot be dismissed as that of a mere conduit through which income flows from the source of the trust to the beneficiary; as the Lord President (Clyde) explained:

> "Unless under very exceptional circumstances, the monies which arise or accrue in the form of income to the trustees, as administrators of the estate under their charge, are not simply passed on to the trust beneficiaries as their income. At the very least, there are administrative charges and expenses to be met which must be paid out of these monies; and in very many cases such monies never reach the hands of any trust beneficiary in the form of income at all."[4]

1. "Loans to Trustees: Section 286": [1980] B.T.R. 413, at p. 415
   S. 16, Finance Act 1973 is discussed below at p. 36 et seq.
2. Tiley, at 17:05 and 17:07. Whiteman and Wheatcroft, 17-02
3. Tiley, at 17:05.
4. Reid's Trustees v. I.R.C., (1929) 14 T.C. 512, at p. 523

Their receipt of, or entitlement to, income as the basis of the trustees' liability to tax is in accordance with the notion that, for income tax purposes, the trust as an entity is disregarded. However, there is some considerable authority to suggest that the entitlement of the trustees to income is not the only basis of their liability. In certain circumstances it would appear that they are treated as acting in a representative capacity and are taxed on behalf of their beneficiaries. This alternative basis of the trustees' liability was introduced in Williams v. Singer.[1]

The Respondents in Williams v. Singer were trustees resident in the United Kingdom; they were trustees of a British trust the beneficiaries of which were resident and domiciled outside of the United Kingdom. The trust property comprised shares in a foreign company: the shares were registered in the names of the trustees. Dividends on the shares were paid direct to the non-resident beneficiaries in compliance with the trustees' order; no income was remitted to the United Kingdom. Nevertheless, the trustees were assessed to tax on the trust income under s. 5, Finance Act 1914 which provided:

> "Income tax in respect of income arising from securities, stocks, shares or rents in any place out of the United Kingdom shall ... be computed on the full amount of the income, whether the income has been or will be received in the United Kingdom or not, ... "

The trustees appealed against the assessment. In the House of Lords Viscount Cave enunciated the following principle:

> "The fact is that, if the Income Tax Acts are examined, it will be found that the person charged with tax is neither the trustee nor the beneficiary as such, but the person in actual receipt and control of the income which is sought to reach. The object of the Acts is to secure for the State a proportion of the profits chargeable, and this end is attained (speaking generally) by the simple and effective expedient of taxing profits where they are found. If the beneficiary receives them, he is liable to be assessed upon them. If the trustee receives and controls them, he is primarily so liable ... But in cases where a trustee or agent is made chargeable with tax, the statutes recognise the fact that he is a trustee or agent for others, and he is taxed on behalf of

1. (1920) 7T.C. 387

> and as representing his beneficiaries or principals ... In short, the intention of the Acts appears to be that, where a beneficiary is in possession and control of the trust income and is sui juris, he is the person to be taxed, and that, while a trustee may in certain cases be charged with tax, he is in all such cases to be treated as charged on behalf or in respect of beneficiaries, who will accordingly be entitled to any exemption or abatement which the Acts allow."[1]

The beneficiaries would not have been liable to tax under s. 5 and therefore the assessment on the trustees failed.

The decision in Williams v. Singer was considered by the Court of Appeal in Kelly v. Rogers.[2] In the latter mentioned case, a United Kingdom resident trustee was entitled to the income arising from foreign stocks and shares, and to income from foreign possessions. There was one beneficiary who was resident in the United Kingdom and who was beneficially entitled to a limited amount of income from the trust for her maintenance; however, there were no ascertainable beneficiaries entitled to the remainder of the income.

The trustee was assessed to tax under Schedule D Case IV, Income Tax Act 1918 on the income arising from the foreign stocks and shares (this was accumulated outside the United Kingdom), and under Schedule D Case V in respect of the income arising from the foreign possessions which was remitted to the United Kingdom.

The assessment was upheld. As there were no ascertainable beneficiaries on whose behalf the trustee could be said to act, she was liable to tax on the trust income. Romer, L.J. explained:

> "Where ... a beneficiary can come and say, "Although the trustee is legally entitled to the income, I am entitled in equity to receive that income or some definite part of it, and if I am entitled to that income or that part of it, as the case may be, at law I should not be liable to be taxed in respect of it," then, of course, the trustee is not chargeable because the beneficiary, on whose behalf and as representing whom the trustee is chargeable, is not himself chargeable. But where there is no such beneficiary, then the trustee remains chargeable; he is the only person who is in fact chargeable in such a case."[3]

1. (1920) 7 T.C. 387, at p. 411.
2. (1935) 19 T.C. 692.
3. (1935) 19 T.C. 692, at p. 713.

The suggestion is that where a non-taxpaying beneficiary is entitled to the income from a trust, the liability to tax of the trustee is absolved.

A more extreme view was presented in Baker v. Archer-Shee in which Lord Hanworth, M.R. commented:

> " ... when you are considering sums which are placed in the hands of trustees for the purpose of paying income to beneficiaries, for the purpose of the Income Tax Acts you may eliminate the trustees. The income is the income of the beneficiaries; the income does not belong to the trustees."[1]

The comment of the Master of the Rolls was endorsed by Lord Carson in the House of Lords.[2] However, it must be appreciated that any remarks in the Archer-Shee case as to the liability of the trustee are strictly obiter; the case concerned the liability of a beneficiary and not a trustee.

The proposition in the Archer-Shee case was not accepted by the Court of Session in Reid's Trustees v. I.R.C.[3] where trustees were assessed to tax under Schedule D Case III of the Income Tax Act 1918 on interest received by them without deduction of tax. On the basis of dicta in the Archer-Shee case and in Williams v. Singer, the trustees argued that the Income Tax Acts did not warrant an assessment on trustees on the income arising under a trust. This contention was firmly dismissed by the Lord President (Clyde) who stated:

1. (1927) 11 T.C. 749, at p.759-760. The case is discussed in detail below.
2. Ibid., at p. 782.
3. (1929) 14 T.C. 512.

> "In both the two English cases ... referred to [i.e., Baker v. Archer-Shee and Williams v. Singer] there are undoubtedly dicta enunciated without apparent qualification, which point to the complete elimination of the trustees in the matter of assessability to Income Tax; but such a consequence was not, I humbly think, really contemplated by the decisions pronounced nor in the judgements by which those decisions were supported."[1]

> "The conclusion on the whole matter seems to be that trustees, albeit only representatives of ulterior beneficial interests, are assessable generally in respect of the trust income under Rule 1 of the Miscellaneous Rules applicable to Schedule D [of the Income Tax Act 1918]; but that - just because they represent those beneficial interests - they may have a good answer to a particular assessment, as regards some share or part of the income assessed, on the ground that such share or part arises or accrues beneficially to a cestui que trust in whose hands it is not liable to income tax, e.g., a foreigner under Case V, Rules 1 and 3.[2]

The recognition that trustees act in a representative capacity is substantially at variance with the original proposition that their liability to tax is attributed to the fact that they are persons who receive or are entitled to income. What is perhaps extraordinary is that in no place do the Income Tax Acts either expressly or impliedly provide that, in certain circumstances, trustees shall be treated as acting in a representative capacity on behalf of their beneficiaries. The notion would appear to have been adopted by the courts purely as a rule of administrative convenience.

Exactly in what circumstances this rule of convenience will be applied is uncertain. It is significant that the case in which

1. (1929) 14 T.C. 512, at p. 524.
2. Ibid., at p. 525. Miscellaneous Rule 1 of Sch. D read: "Tax under this Schedule shall be charged on and paid by persons or bodies of persons receiving or entitled to income in respect of which tax under this Schedule is ... to be charged." See now s. 114(1), I.C.T.A.
   It should be noted that while it may be apt to describe trustees as 'representatives of ulterior beneficial interests', trustees do not act in the capacity of agent to the beneficiary - see Viscount Sumner in Baker v. Archer-Shee, (1927) 11 T.C. 749, at p. 766-767. For the avoidance of doubt the distinction is considered in more detail in Appendix 2.

trustees have been recognised as acting in a representative capacity involved beneficiaries who were not liable to tax. It would appear that the principle operates as a defence to an assessment and will not serve to create additional liability in the trustee. It is doubted, therefore, that trustees could be recognised as 'representatives of ulterior beneficial interests' for the purposes of assessing them to tax at the higher rates applicable to a beneficiary.[1] Whiteman and Wheatcroft noted:

> "(i) income of a trust which is paid directly to a beneficiary without passing through the hands of a trustee is not assessable on the trustee,[2] and (ii) a trustee may have a good answer to a particular assessment as regards some share or part of the income assessed, on the ground that such share or part arises or accrues beneficially to a cestui que trust in whose hands it is not liable to income tax."[3]

It is also of significance that, so far, the rule had been applied in a trust case which involved a foreign element. It is improbable therefore that it could be applied to absolve the liability of trustees where both they and their beneficiaries are resident in United Kingdom and where those beneficiaries have unused personal allowances.

Thus, where there are trustees resident in the United Kingdom who receive income from foreign sources and where the beneficiaries to whom that income will eventually be paid are resident out of the United Kingdom, it is likely that the rule of convenience will be applied; the trust will be recognised and the trustees will be treated as representatives of the beneficiaries. The trustees will have a good answer to any assessment made upon them.

1. The fact that trustees are not 'individuals' would not inhibit the charge: they would be taxed on behalf of an individual.
2. This is the alternative view which may be taken of the decision in Williams v. Singer.
3. 17-02.

Obviously, it cannot be said without qualification that trustees are liable to tax on the basis that they are persons who receive or are entitled to income. This is so despite the fact that the Income Tax Acts provide no alternative basis for their liability. The rule of convenience that trustees may be recognised as acting in a representative capacity, as it has been applied in the courts, might accord with notions of 'common sense' or 'fairness' but it demonstrates that the schedular system of income taxation is not rigorously applied to the trust concept in so far as the liability of the trustee is concerned.

Consideration must be given here to s. 76, Taxes Management Act 1970, which reads as follows:

> "A trustee who has authorised the receipt of profits arising from trust property by, or by the agent of, the person entitled thereto shall not, if -
>
> (a) that person or agent actually received the profits under that authority, and
> (b) the trustee makes a return, as required by section 13 of this Act, of the name, address and profits of that person,
>
> be required to do any other act for the purpose of the assessment of that person to income tax."

In Simon, s. 76 is used as the authority for the following proposition:

> "Where ... income is received direct by a beneficiary by the trustee's authority, so that the former is in immediate control of it, it is the beneficiary who is assessed."
>
> "S 76 protects the trustee in such a case, if he returns a list under T.M.A. 1970, s13."[1]

Pinson suggests s. 76 provides:

> "Where income is received direct by the beneficiary under the authority of the trustees, the beneficiary may be assessed instead of the trustees."[2]

1. E6.302
2. Pinson on Revenue Law 13th ed., 9:13.

Both the interpretations of s. 76 quoted above are a little misleading. S. 76 does not absolve the trustees' liability to tax where they have authorised the receipt of the trust income directly by the beneficiary. S. 76 has no real bearing on the liability of the trustee; it is silent in that respect. It is purely an administrative provision which relates to the assessment of beneficiaries and not of trustees.

TAXATION OF THE BENEFICIARY

Like the trustee, the beneficiary is liable to tax on the basis that he is a person who receives or is entitled to receive income. However, it is in respect of the income of beneficiaries that the trust operates as an intermediary; it stands between the source of the trust's income and the ultimate recipients. This factor is reflected to a certain extent in the problems associated with the taxation of beneficiaries.

A beneficiary may be assessed to tax only under the Schedule appropriate to the source of his income. The source of a beneficiary's income depends upon the nature of his interest under the trust.

Assuming there exists a Schedule under which the beneficiary may be assessed, it is necessary to ascertain the amount of income on which tax may be charged. The amount of income to which a beneficiary is entitled usually depends upon the construction of the trust deed.[1]

Thus the process of taxation is in two stages: first, the appropriate Schedule must be identified and, secondly, the amount of income to which a beneficiary is entitled must be ascertained.

1) Identifying the appropriate Schedule

It was noted above that the Schedule under which a beneficiary may be assessed to tax is that appropriate to the source of his income,

1. Macfarlane v. I.R.C., (1929) 14 T.C. 532, at p. 540. See below at p. 34.

and that the source of a beneficiary's income is determined by reference to the law which governs the nature of the beneficiary's interest under the trust.

The theoretical problem which will be discussed here may be stated quite shortly: "Is the beneficiary entitled to the income of the trust, or is he entitled merely to income from the trust?"

If his entitlement is to the income of the trust then he must be assessed to tax under the Schedule appropriate to the source of the trust's income (usually theSchedule under which the trustee is charged). If his entitlement is to income from the trust then the source of the trust's income will not affect the Schedule under which the beneficiary is charged; in respect of trusts which are resident and domiciled in the United Kingdom the appropriate Schedule must be Schedule D Case III.

Annuitants

At the outset the distinction must be drawn between a beneficiary of a trust who is entitled to the income arising thereunder and an annuitant under a trust who is entitled to the payment by the trustees of a specified annual sum. The taxation of an annuitant is relatively straight forward. In Simon it is noted:

> "An annuitant under a trust is in the same position as any other person entitled to an annuity. The annuity is a separate source of taxable income ..."[1]

An annuitant is chargeable to tax under Schedule D Case III on the income he receives - receivability being nothing without receipt.[2]

1. E6.315.
2. I.R.C. v. Whitworth Park Coal Co. Ltd., (1961) 38 T.C. 531: Dewar v. I.R.C., (1935) 19 T.C. 561: Woodehouse v I.R.C. , (1936) 20 T.C. 673. Cf. Stamp. L.J. in Dunmore v. McGowan, /‾1978_7 S.T.C. 217, at p. 219 - " ... the doctrine that 'receivability without receipt is nothing' is a doctrine which can be pressed too far."

An annuitant under a trust is clearly a beneficiary; however, this discussion is concerned with beneficiaries who are entitled to the income arising under a trust and not merely to a specified annual sum.

Beneficiaries other than annuitants

It is the law of the particular state or country in which a trust is constituted and domiciled that determines the nature of the beneficiary's interest under the trust. It is, therefore, the laws of the United Kingdom which determine the rights of the beneficiary of a trust constituted and domiciled in the United Kingdom and which in turn determine the Schedule under which the beneficiary is to be charged to tax.[1] The position may be illustrated by reference to the controversial decision of the House of Lords in Baker v. Archer-Shee, the implications of which will now be considered at length.

The Baker v. Archer-Shee controversy[2]

The facts in the case were as follows. The beneficiary was the sole life tenant under the will trust of an American citizen. The trust was constituted and domiciled in the State of New York but the beneficiary was resident in England. The trustee was a New York trust company, and the trust fund comprised, inter alia, foreign securities, stocks and shares. The trustees paid the income from the trust fund to a bank in New York: no income was remitted to the beneficiary in England.

The beneficiary[3] was assessed to tax on the income arising from the trust fund, although the Crown, by concession, withdrew their claim to assess so much of the income that was consumed in meeting the trust administration expenses.

1. In Appendix 3 it is attempted to state concisely the nature of the beneficiary's interest according to the laws of Scotland and England: the decision in Baker v. Archer-Shee is, however, ignored. The purpose of omitting any discussion of the Archer-Shee case in Appendi is to emphasise the impact of the decision on long settled legal theo
2. (1927) 11 T.C. 749.
3. In actual fact it was the beneficiary's husband who was assessed, but this is immaterial to the present discussion.

The charging provisions involved in the case were Schedule D Cases IV and V, Income Tax Act 1918. Schedule D Case IV charged tax on income arising from foreign securities; Schedule D Case V Rule 1 charged tax on income arising from foreign stocks and shares, and Schedule D Case V Rule 2 charged tax on income arising from foreign possessions but received in the United Kingdom. Lord Wrenbury explained the operation of these provisions:

> "My Lords, Section 1 of the Income Tax Act 1918, enacts that Income Tax for any year 'shall be charged for that year in respect of all property, profits, or gains respectively described or comprised in the Schedules marked A, B, C, D, and E'. I note here the words 'all property'.
>
> "Schedule D enacts that tax under that Schedule shall be charged in respect of (a) the annual profits or gains arising or accruing - (i) to any person residing in the United Kingdom 'from any kind of property whatever, whether situated in the United Kingdom or elsewhere'. It further enacts that tax under the Schedule shall be charged under certain Cases and after specifying five Cases it adds:-
> Case VI. - 'Tax in respect of annual profits or gains not falling under any of the foregoing Cases, and not charged by virtue of any other Schedule'. No words could be more plain to include all annual profits of every kind.
>
> "Case V, however, which relates to 'possessions out of the United Kingdom', consists of two parts. The former has to do with 'stocks, shares or rents in any place out of the United Kingdom' - the latter with 'possession out of the United Kingdom, other than stocks, shares or rents'. In the latter case the tax is to be computed only 'on the full amount of the actual sums annually received in the United Kingdom'.
>
> "The result of the above may be shortly stated by saying that, in the case of a person residing in the United Kingdom all his property whatever, situated in the United Kingdom or elsewhere, is charged to tax, but if he shows that a particular part of his property is within Cases V, Rule 2, then the tax is computed only upon so much of the income as is actually received in the United Kingdom."[1]

1. (1927) 11 T.C. 749, at p 777.

The beneficiary resisted the assessment claiming that she was not entitled to the income arising from foreign securities, stocks and shares. Her only right was to have the trust administered; that right was a foreign possession and the income arising therefrom was assessable only in so far as it was received in the United Kingdom under Schedule D Case V Rule 2.[1]

As no evidence was submitted as to the nature of the beneficiary's interest according to the law of the State of New York, it was presumed that her interest was of the same nature as that of a beneficiary of a trust constituted and domiciled in England.

The majority of the judges who heard the case sympathized with the contention that the beneficiary's right was a right to have the trust administered only: it was a mere jus in personam. Rowlatt, J. explained:

> "What this lady enjoys is not stocks, shares and rents or other property subject to the will, but what she does enjoy and has got is the right to call upon the trustees, and to force the trustees if necessary, to administer this property during her life so as to give her the income arising therefrom, according to the trust. Her interest is that of equity and is not an interest in the specific stocks and shares at all. There is no doubt about the correctness of that."[2]

The beneficiary's right as a jus in personam would have entitled her to receive whatever income might have been available after the administration of the trust. Clearly, this would not have been a right to income arising from specific items in the trust fund.

The majority in the House of Lords, however, took the opposite view. Lord Wrenbury stated the case thus:

1. Para. 5 of the Case stated.
2. Ibid., at p. 754.

"In this state of facts [the beneficiary's] interest under her father's will is beyond all question "property". The question for determination is what is the nature of that property, is it a "possession out of the United Kingdom other than stocks, shares or rents" within Case V, Rule 2? To escape taxation the [beneficiary] must establish that it is."[1]

So far as the majority in the House of Lords was concerned, it was immaterial that the beneficiary could receive only the net balance sum of the trust income after the deduction of administration expenses. They held that she was entitled to the entire income of the trust Lord Carson opined:

" ... upon the construction of the will ... once the residue had become specifically ascertained, the [beneficiary] was the sole beneficial owner of the interest and dividends of all securities, stocks and shares forming part of the trust fund therein settled and was entitled to receive and did receive such interest and dividends. This, I think, follows from the decision of this house in Williams v. Singer ... and in my opinion the Master of the Rolls correctly stated the law when he said 'that when you are considering sums which are placed in the hands of trustees for the purpose of paying income to beneficiaries, for the purpose of the Income Tax Acts you may eliminate the trustees. The income is the income of the beneficiaries; the income does not belong to the trustees'."[2]

Lord Wrenbury stated:

" ... the question is not what the trustees have thought proper to hand over and have handed over (which is a question of fact) but what under the [trust the beneficiary] is entitled to (which is a question of law). The trustees, of course, have a first charge upon the trust funds for their costs, charges and expenses. But this does not reduce the right of property of the beneficiary to a right only to a balance sum after deducting these."[3]

Accordingly the beneficiary was assessed to tax on the income arising from the securities, stocks and shares: it was of no consequence that the income was not remitted to the United Kingdom.

1. (1927) 11 T.C. 749, at p. 778.
2. Ibid., at p. 782. Lord Hanworth, M.R. at p. 759-760. It will be recalled that the statement of the Master of the Rolls was not accepted by The Lord President (Clyde) in Reid's Trustees v. I.R.C (1929) 14 T.C. 512, at p. 524; supra, at p. 8.
3. (1927) 11 T.C. 749, at p. 778-779. On this basis it would appear to have been unnecessary for the Crown to have withdrawn their claim to assess the income which was consumed in meeting the trust administration expenses.

Thus, as the nature of the property of the beneficiary was not a "possession out of the United Kingdom other than stocks, shares or rents", the beneficiary must have been attributed property rights in the stocks and shares which comprised the trust fund.

The decision is undoubtedly inconsistent with the theory that the nature of a beneficiary's interest is that of a jus in personam, to compel due administration of the trust and to receive whatever income may be available thereafter.[1] It is demonstrated in Appendix 3 that the right of a beneficiary under a trust is 'property'. It is, as Professor Langdell indicated, a right in rem in that it imposes a negative duty on the world at large not to interfere with the obligation of the trustee owed to the beneficiary.[2] But surely in Baker v. Archer-Shee such property would have been a 'foreign possession', the income arising therefrom being assessable on a remittance basis under Schedule D Case V, Rule 2.

On the basis of the Archer-Shee decision, it would appear that the Schedule under which a beneficiary is to be assessed on the income to which he is entitled by virtue of the trust is that appropriate to the source of the trust's income. He is entitled to the income of the trust and not merely to income from the trust.

Baker v. Archer-Shee was blindly followed in the Kings Bench Division in the case of Nelson v. Adamson,[3] the facts of which were as follows. By the terms of a will trust made in England trustees in Australia held various foreign securities in trust. They were obliged to make an annuity payment out of the trust income; any income remaining thereafter was payable to the Appellant who was resident in England. None of the remaining income was remitted to the United Kingdom.

1. See Appendix 3, at p. xvii et seq.
2. Ibid., at p. xix.
3. [1941] 2 K.B. 12.

The Appellant was assessed to tax under Schedule D Case IV, Income Tax Act 1918 on the income arising from the foreign securities. She contended that the assessment had been wrongly made, arguing that her only right was to compel due administration of the trust: she had no property right in the foreign securities.

The court held that the Appellant was assessable under Schedule D Case IV Rule 1, on income arising from specific securities out of the United Kingdom. The case was dismissed as being materially indistinguishable from Baker v. Archer-Shee.

Bearing in mind the remarks of Lord Wrenbury in the Archer-Shee case, that 'in the case of a person residing in the United Kingdom all his property whatever, situated in the United Kingdom or elsewhere, is charged to tax',[1] the proposition in Nelson v. Adamson is curious. The implication is that, despite the prior right of the annuitant, the Appellant had a property right in the specific securities which the trust fund comprised. If the annuity payable from the trust fund was £100, and in 1938 the trust income was £200, presumably the Appellant would be said to have a property right in half the trust fund. However, if in 1939 the trust income was £150, it would follow that the Appellant would be attributed a property right in one third of the specific securities. It is a strange thing that fluctuations in the income of the trust can alter the property right of a beneficiary.

The decision of the House of Lords in the Archer-Shee case has been met with considerable criticism. Professor Hanbury remarked:

> "A student beginning the study of equity cannot do better than to soak himself in the incomparable book written on the subject by Professor Maitland. That very learned author, even at the risk of monotony, pronounces and reiterates the root principle that equitable rights and interests are not jura in rem. They much resemble these, but the dividing line appears at once in the recollection of the bona fide purchaser for value of the

1. (1927) 11 T.C. 749, at p. 777, supra, at p.14.

legal estate. Of course this distinction is only necessary for the lawyer; the layman finds it naturally convenient enough to regard a cestui que trust as an absolute owner and to stigmatize as pedantic and, if the word may be used in this connexion, slightly 'priggish', the insistence of a lawyer, with Maitland, on the undoubted character of the cestui que trust's interest as a mere ius in personam. Now nobody relishes the imputation of 'priggishness', so the lawyer is ready enough to adopt lay phraseology, and to talk loosely of 'equitable ownership'. The utter chaos which would result if it were really true, that equity regarded A as owner, while law so regarded B, he well knows, but in nine cases out of ten this looseness of language produces no ill effects. But unfortunately there always arises the periodical tenth case, where looseness of language may lead to looseness of thinking, and looseness of thinking to a decision round which criticisms subsequently rage and will not be checked."[1]

> " ... now looseness of language and forgetfulness of 'Maitland's axiom' have led to another decision which, unless explicable as pure 'income tax law' and therefore not to be widely construed, stands, it is submitted, as a contradiction of clear equitable principle. This decision is Baker v. Archer-Shee ..."[2]

It is instructive to compare the Archer-Shee case with that of Schalit v. Nadler.[3] In Schalit v. Nadler certain premises were demised for a fixed term to N as lessee. These premises were sublet to the plaintiff, S.

N, by declaration of trust, constituted himself as trustee of the property demised by the lease. He declared that he would hold, and continue to hold the property in trust for the defendant company "absolutely to sell, let or otherwise (wholly or in part) as the company may direct or appoint and in the event of such sale

1. "A Periodical Menace to Equitable Principles": (1928) 44 L.Q.R. 468 at p. 468.
2. Ibid., at p. 469.
3. [1933] 2 K.B. 79.

or letting to hold the net proceeds thereof upon trust for the company to invest or otherwise as the company may direct."[1]

S, the plaintiff sublessee, fell into arrears with the rent. The defendant company (the beneficiary of the trust declared) instructed a bailiff to enter the premises and to seize and distrain goods and chattels belonging to S in order to secure the rent due. S brought an action against the defendant company for illegal distress.

According to the provision of s. 141(2), Law of Property Act 1925, rent reserved by a lease 'shall be capable of being recovered, received, enforced, and taken advantage of, by the person from time to time entitled ... to the income of the land leased.'

It was argued by the plaintiff that the defendant company, being the mere beneficiary of a trust, was not entitled to the income of the land leased and that, therefore, the distress was wrongful. Goddard, J. upheld the plaintiff's contention.

> "The right of the cestui que trust whose trustee has demised property subject to the trust is, not to the rent, but to an account from the trustee of the profits received from the demise ... The cestui que trust has no right to demand that the actual bank-notes received by the trustee shall be handed over to him or that a cheque for rent drawn to the trustee shall be indorsed over. What he can require is that the trustee shall account to him, after taking credit for any outgoings or other payments properly chargeable, for the profits received from the trust property."[2]

1. Ibid., at p. 80.
2. Ibid., at p. 83.

It is difficult if not impossible to reconcile this decision with that in Baker v. Archer-Shee. Sir David Hughes Parry noted:

> "It seems well-nigh impossible to 'distinguish' the two cases, and for that reason it is submitted that the Schalit's case was wrongly decided."[1]

Of course, it may be that the Archer-Shee case is explicable as pure 'income tax law', and that, therefore, the Schedule under which a beneficiary may be taxed has nothing to do with the law of trusts. This perhaps may be a preferable interpretation of the case. If the decision was based on a finding of trust law, its effect must be confined to trusts south of the border. The general principle is recited in Whiteman and Wheatcroft:

> "Before applying taxation laws, the true legal effect of any transaction entered into by a taxpayer must first be ascertained and if, as a result of differences between the law of England and that of Scotland, the same transaction has a different effect in the two countries, then different taxation consequences may well result."[2]

As it will be demonstrated later, the nature of the beneficiary's interest under a Scottish trust would appear to be nothing more than a right to have the trust administered.[3] Thus the beneficiary of a Scottish trust would be entitled to income from the trust whereas, in accordance with the Archer-Shee decision, the beneficiary of an English trust would be entitled to the income of the trust. Although their positions in substance might be identical, they may be assessed to tax under different Schedules.

Baker v. Archer-Shee: trust law or tax law?

In the light of the decision of the House of Lords in Archer-Shee v. Garland[4] it is difficult to conclude otherwise than that the decision in

1. (1934) 50 L.Q.R. 158, at p. 159.
2. 1-51. Judicial authority for this principle is found in Lord Advocate v. Gunning's Trustees, 1907 S.C. 800
3. Infra, p.26-29. See also Appendix 3, p. xi - xvi.
4. (1931) 15 T.C. 693.

Baker v Archer-Shee was based upon a finding of English trust law. However, before discussing the facts in the Garland case, consideration will be given to the theories which tend to support the proposition that the decision in Baker v. Archer-Shee is explicable as pure income tax law.

Lord Sands in Reid's Trustees v. I.R.C. exposed himself as a proponent of the 'pure income tax law' theory. Having presented the material facts of the Archer-Shee case, he continued:

> "The matter turned, under Rules 1 and 2 of Case V, Schedule D, upon the question whether the income enjoyed by Lady Archer-Shee [the beneficiary] arose from "stocks, shares or rents", or from "other possessions". Here ... there was, as indeed the difference of judicial opinion in the Archer-Shee case shows, room for either of two views. The one was that regard must be had to the substance of the matter, and that when this was had there could be no doubt that the source - the thing from which the income arose - was dividends on stocks and shares. The other view was that form must prevail and that technically the source of the income was not stocks and shares but a beneficial interest in a trust estate. By a majority of three to two the House of Lords decided in favour of the former view, overruling an unanimous judgement of the Court of Appeal. This was the sole subject matter of decision in the case. Notwithstanding the narrowness of the majority, the decision is of course binding upon us, as is any implication which necessarily underlies it."[1]

Lord Sands suggested that the basis of the decision in the Archer-Shee case was that, according to the substance of the matter, the beneficiary's income comprised the dividends from "stocks, shares or rents", and that for the purposes of the Income Tax Acts it is the substance of the matter that determines what a beneficiary is entitled to. Thus, according to Lord Sands, the trust law which determines the nature of a beneficiary's interest is irrelevant. The theory is that substance prevails over form.

Two further theories on the Archer-Shee decision have been presented in the pages of the Canadian Bar Review.

1. (1929) 14 T.C. 512, at p. 528.

Latham suggested 'that the decision may have been correct of principles of convenience.'[1] He opined:

> "Economically, Lady Archer-Shee was owner of the particular funds for her life-time, and tax should be imposed on economic grounds. But I hope that the decisions will not be extended to other branches of law without careful consideration of the expediency of the particular extension. It may be that for many purposes the beneficiary should be treated as owner of the trust assets, but if he is so treated for all purposes, why set up the trust machinery in cases where it is possible to create corresponding legal interests?"[2]

Of the decision in Nelson v. Adamson, Latham concluded:

> "But although the case may be difficult to reconcile with principle, it may be expedient to assess such a beneficiary on the ground that economically he is in much the same position as the owner, when allowance is made for the annuity."[3]

Latham excused the apparent inconsistency of the judgement of Goddard, J. in Schalit v. Nadler with the decision in Baker v. Archer-Shee:

> " ... why should a decision on the construction of the Income Tax Act be binding on the construction of the Law of Property Act: the former concerned the economic interest of the beneficiary, the latter the machinery for enforcing it? Is it surprising, then, that in the latter the technical position should be of more importance?"[4]

In conclusion Latham noted:

> "Technically the cestui que trust has no interest in specific items of the trust fund, but merely a right to its due administration, enforceable against the trustees and situated where they may be sued - their residence. Where, however, problems of social and economic importance are involved, the courts often attach the interest to specific trust assets."[5]

1. "Specific Items of the Trust Fund": (1954) 32 Can. B.R. 520, at p.536
2. Ibid., at p. 536.
3. Ibid., at p. 536.
4. Ibid., at p. 537.
5. Ibid., at p. 544.

A broadly similar argument was presented by Professor Waters. Professor Waters argued that the 'genius of the use and of the trust was that it contemplated a separation of the beneficial interest from the dispositive and managerial interests.' Baker v. Archer-Shee was not concerned with the separation of these interests and, therefore, the decision did no violence to equitable principles. The reasoning of Professor Waters is evident from his following statements; having briefly stated the facts of the case he continued:

> "The question is as to the interest of the life tenant at a particular time in the dividends of those investments. The equitable estate concept is serving no function at this single point of time; it is juristic lumber. There is (1) no class or number of beneficiaries simultaneously possessing a similar right of enjoyment in the trust property; there is (2) no uncertainty as to what specific assets constitute trust assets; there is (3) no question as to the period of time during which there is to be a right of enjoyment, now or in the future. Why not ignore the equitable estate, and recognise the fact that this beneficiary's right of enjoyment is actually in the specific dividends?"[1]

> "The issue did not concern a dispute between life tenant and remainderman, the duties of the trustee, or the rights and duties of the life tenant vis-a-vis third parties. It raised a type of question, perhaps the unusual question, where it was arguably mere pedantry to bar the Commissioner of Taxes with the equitable estate of the life tenant. One says arguably, because it is just possible to say that, though the equitable estate served no function in the circumstances, nevertheless the taxpayor was entitled to take advantage of its presence. The writer for his part, however, would suggest that that is an unattractive argument since it turns the creative genius of the trust into an instrument of unmeritorious frustration."[2]

The suggestion is that the rights of a beneficiary should be determined according to the nature of the case before the court. Problems concerning the actual working of the trust should be decided in accordance with established equitable principle, but in other cases, notably those concerning the claims of the revenue authorities, the

1. "The Nature of the Trust Beneficiary's Interest": (1967) 45 Can B.R. 219 at p. 228.
2. Ibid., at p. 229.

equitable estate serves no purpose and should be ignored; the beneficiary should be recognised as enjoying the income from specific items in the trust fund.[1]

The theories outlined above must be read in conjunction with the decision of the House of Lords in Archer-Shee v. Garland[2] the facts of which were materially indistingushable from those of the earlier case of Baker v. Archer-Shee. However, in Garland's case the evidence was heard of a New York lawyer who testified that according to the laws of New York the right of the beneficiary was merely to compel due administration of the trust. It was not, as the House of Lords had presumed in Baker v. Archer-Shee, a right to the income arising from the specific stocks and shares comprising the trust fund. The beneficiary in Garland's case, therefore, could be assessed to tax only under Schedule D Case V Rule 2 of the I.T.A. 1918 on income arising from a foreign possession and actually received in the United Kingdom.

It is clear in the light of Garland's case that the decision in Baker v. Archer-Shee cannot be interpreted as determining that, in substance, the beneficiaries income was derived from specific stocks and shares. The substance of the matter in both the Garland and Baker cases was identical. By comparing the two cases it becomes apparent that the courts were concerned with the technicalities of the beneficial interest under a trust. It was not as Lord Sands suggested, simply a case of substance prevailing over form.[3]

It is also apparent that the decision in Baker v. Archer-Shee cannot be justified on the grounds that the beneficiary was 'economically' the owner of the specific items of the trust fund. In Garland's case the beneficiary was equally 'economically' the owner of the trust fund but she was not assessed to tax on the basis that her income arose from specific stocks and shares.

1. Ibid., at p. 280-281. Waters also noted that support for the decision in Baker v. Archer-Shee might be found in several Commonwealth cases, in particular Syme v. Commissioner of Taxes, [1914] A.C. 1031; ibid., at p. 243 et seq.
2. (1931) 15 T.C. 693.
3. Supra, at p. 22. Reid's Trustees v. I.R.C. was decided before Garland's case.

It is indisputable in view of the decision in Garland's case that it is the technical nature of the beneficiary's interest under a trust that determines under which Schedule he is to be assessed to tax. For this reason it becomes difficult to describe the decision in Baker v. Archer-Shee as being based on pure income tax law.[1]

Consistently with the decision in Baker v. Archer-Shee, the nature of the beneficiary's interest under an English trust is a right to the income arising from the specific items of the trust fund. It may be that, as both Latham and Waters suggested, the rule in Baker v. Archer-Shee applies only in cases of 'social and economic importance' and not to cases concerning 'a dispute between life tenant and remainderman' or 'the rights and duties of the life tenant vis-a-vis third parties.' A criticism of such a theory lies outside the scope of this work: however, the difficulties are obvious; it will suffice here to pose the rhetorical question: "What constitutes a case of social and economic importance?"

Thus, it would appear that as a matter of English law, the beneficiary of an English trust must be assessed to tax on the basis that he is entitled to the income of the trust. However, the position of the beneficiary of a Scottish trust cannot be stated with such certainty.

Baker v. Archer-Shee in Scotland

It has been noted above that Lord Sands in Reid's Trustees v. I.R.C. considered that the decision in Baker v. Archer-Shee was binding upon the Court of Session.[2] It has also been noted that, on the basis of the decision in Archer-Shee v. Garland, Lord Sands misinterpreted the Baker case as being founded on a rule of pure income tax law that in substance a beneficiary is entitled to the income arising from the specific items of the trust fund[3]. The dicta of Lord Sands is, therefore, no authority for the proposition that Scottish courts are

1. This much was accepted by Latham who noted that the Garland case 'would appear to show that Baker v. Archer-Shee determines the rights of beneficiaries apart from revenue law.' - 32 Can. B.R. 520, at p. 536, n. 84.
2. (1929) 14 T.C. 512, at p. 539: supra, at p. 22.
3. Supra, p. 25.

bound by the decision in Baker v. Archer-Shee, a decision which, as it has been demonstrated, appears to have been based upon a finding of English trust law.

In order to assess the effects of Baker v. Archer-Shee on the taxation of the beneficiary of a Scottish trust consideration may be given only to the views expressed by Scottish courts after the decision in Garland's case. A relevant case is that of I.R.C. v. Clark's Trs.[1]

I.R.C. v. Clark's Trs. was an estate duty case the facts of which were as follows. An American subject domiciled in the State of New York conveyed property, including shares in a United Kingdom company, to trustees to hold on trust to pay the income therefrom to himself during his life; thereafter the income was to be paid to beneficiaries in Scotland.

The settlor died and the question of estate duty arose. S. 1 of the Finance Act 1894 enacted:

> "In the case of every person dying ... there shall ... be levied and paid, upon the principal value ascertained as hereinafter provided of all property, real or personal, settled or not settled, which passes on the death of such a person a duty, called 'Estate Duty' ... "

Estate duty was charged on the death of the settlor. As a result of the decisions in the Scottish cases of Cowley v. I.R.C.[2] and Dunderdale's Trustees v. I.R.C.[3] the property which passed on the death of a liferenter was not the beneficial interest in the trust fund but the fund itself. The decisions were not based upon a finding that the beneficiary of a Scottish trust has a proprietary interest in the trust fund: it was found that Parliament had intended that the trust property was to be treated as passing on the death of the liferenter.

1. 1939 S.C. 11.
2. [1899] A.C. 198.
3. 1936 S.C. (H.L.) 20.

Nevertheless, the defenders in I.R.C. v. Clark's Trs. attempted to distinguish their case from those of Cowley and Dunderdale. They argued that those cases were decided upon the grounds that the beneficiary of a Scottish trust has an interest in the trust res, whereas the beneficiary of a trust constituted and domiciled in the State of New York had a mere personal right of action against the trustee to compel due performance of the trust.

In rejecting the defender's contention, the court demonstrated that a beneficiary's right under a Scottish trust was the same as that of a beneficiary of a trust constituted and domiciled in the State of New York. The Lord President (Normand), having discussed the decision in Archer-Shee v. Garland, continued:

> "There had been an earlier case [Baker v. Archer-Shee] between the same parties, in which a different result had been reached, because in that earlier case it was assumed that the beneficiary's right under American law was the same as his right would have been under the law of England, and apparently, as Lord Wrenbury said in the earlier case, under the law of England a beneficiary such as a liferenter is entitled in equity and specifically during his life to the dividend upon stocks held by the trustees, or to an equitable right in possession to receive during his life the proceeds of the shares and stocks of which he is tenant for life.
>
> "Now, no Scottish lawyer would describe the rights of a liferenter in these terms, which are entirely alien to our law. Lord Sumner was in the minority in the first of the Archer-Shee cases, and if his view had prevailed, the decision in the first Archer-Shee case would have been, not the decision which was actually given in it, but the decision which was given in the second of the Archer-Shee cases. He supported Sargant, L.J., who adopted the language of Rowlatt, J. who said: 'What this lady enjoys is not the stocks, shares and rents or other property constituting the trust fund under the will; what she has is the right to call upon the trustees, and if necessary, to compel the trustees, to administer this property during her life so as to give her the income arising therefrom according to the provision of the trust. Her interest is merely an equitable one, and it is not an interest in the specific stocks and shares constituting the trust fund'. In my opinion, that is a very accurate description of the rights of a beneficiary enjoying a liferent under a Scottish trust deed, and, as was pointed out by Lord Dunedin, it is a very good description of what was proved to be the law of the State of New York in the second Archer-Shee case."

"My conclusion is that there is no difference between the law of Scotland as regards the beneficiary's rights and the law which is admitted in the record to be the law of the State of New York."[1]

Thus the nature of a beneficiary's interest under a Scottish trust is, as it is noted in Appendix 3, a personal right of action against the trustee.[2] It would appear that the decision in Baker v. Archer-Shee has little application in Scotland: the logical conclusion is that the beneficiary of a Scottish trust must be assessed to tax on the basis that he is entitled to income from the trust. It necessarily follows that the source of the trust's income will not affect the Schedule under which he is charged to tax. This is not the position of the beneficiary of an English trust. Thus there is some theoretical disparity in the treatment for tax purposes of beneficiaries of Scottish and of English trusts.

The disparity: its practical significance and a possible reconciliation

At the outset it must be stated that the theoretical disparity which must arise by reason of the difference in the nature of the beneficial interest under a Scottish trust and that under an English trust is of little practical significance.

The beneficiary of an English trading trust will be assessed to tax under Schedule D Case I, I.C.T.A., (the income which he receives will usually have been taxed in the hands of the trustees and will therefore be net of basic rate tax). In accordance with the decision in I.R.C. v. Clark's Trs.,[3] the beneficiary of a Scottish trading trust is not entitled to the profits of the trade; he will be assessed to tax under Schedule D case III on the income that he receives from the trust. Both beneficiaries are assessed to tax but under differing Cases; however, there would appear to be no harm in this.

1. 1939 S.C. 11, at p. 23-24.
2. This is reflected in the Capital Transfer Tax legislation in which a definition of an 'interest in possession in settled property' is provided for Scotland but not for England: para. 1(9) of Schedule 5 to the Finance Act 1975 (as amended). It has been suggested that the definition was necessary by reason of the fact that the beneficiary has no interest in settled property, but only a personal right of action against the trustee: Foster, at C1.04, at C114; Dymond at p. 571-572.
3. 1939 S.C. 11.

The disparity may be of significance where the rules of one Schedule are more favourable than those of another. A possible example in which the disparity may be of some practical consequence would be in respect of trust income comprising rents under leases of land in the United Kingdom.

The beneficiary of an English trust would be the person receiving or entitled to the rents under the leases and would therefore be charged under Schedule A.[1]

Not so the beneficiary of a Scottish trust. He would be assessed to tax under Schedule D Case III. His income would arise from 'property'; the property being his personal right of action against the trustee.

This may be a curious anomaly even though it is apparently harmless; both beneficiaries are assessed to tax albeit under differing charging provisions. However, the matter cannot rest there.

Assume that both beneficiaries have 'private' incomes apart from the income which they receive under their trusts. These 'private' incomes are derived from rents under leases of land in the United Kingdom on which both are assessed to tax under Schedule A. Both beneficiaries undertake extensive repairs to their premises the allowable deductions in respect of which exhaust the rents received under the leases. Section 72(4), I.C.T.A. provides:

> "In the case of a lease at full rent, not being a tenants repairing lease, there may also be deducted the amount of any payment made in respect of other premises by the person chargeable ... "

It would appear that the English beneficiary may set his loss against the income that he receives by virtue of the trust. The beneficiary of the Scottish trust whose income is charged to tax by virtue of Schedule D Case III has no such right of deduction. This is a necessary consequence of the strict rule that the Schedules are mutually exclusive.[2]

1. S. 68(1), I.C.T.A.
2. Mitchell and Edon v. Ross, (1961) 40 T.C. 56. Supra, at p. 1.

The disparity may also be of significance in respect of building society interest.

Trustees who receive building society interest cannot be assessed to tax thereon.[1] The beneficiary of an English trust who is entitled to the interest will be treated as receiving an amount of income equal to the interest received grossed up at the basic rate of tax.[2] He may be assessed to tax at the higher rates on the grossed up amount of the interest.[3]

However, the beneficiary of a Scottish trust is not entitled to the building society interest as such. He cannot be treated as receiving an amount of income equal to the amount of the interest grossed up at the basic rate under s. 343(3)(c), I.C.T.A., likewise, the amount to which he is entitled will not be treated as having suffered tax at the basic rate. The trustees, on handing over the interest to the beneficiary will be entitled to deduct tax under s. 52 or 53, I.C.T.A.[4] The beneficiary will therefore, in theory, receive less net income than the beneficiary of an English trust.

Clearly, it would be desirable if the disparity could in some way be reconciled. As it has been demonstrated, it is not enough simply to state that, no matter where a trust was constituted or is domiciled, the beneficiary shall be treated as being entitled to the income from the specific items of the trust fund. Had this been so, Archer-Shee v. Garland[5] would not have been decided as it was: it is undoubtedly the technical nature of the beneficiary's interest under the trust that determines under which Schedule he is to be assessed to tax.

1. S. 343(3)(b), I.C.T.A.
2. S. 343(3)(c), I.C.T.A.
3. Proviso (i) to S. 343(3), I.C.T.A.
4. S. 343(3)(d), I.C.T.A.: the beneficiary will receive the amount of interest (not its grossed up equivalent) less tax at the basic rate.
5. (1931) 15 T.C. 693.

However, a restrictive interpretation of Baker v. Archer-Shee may be acceptable; the case may be interpreted as overriding United Kingdom trust law for the purposes of the Income Tax Acts. Thus for the purpose of assessing the beneficiary of a trust constituted and domiciled anywhere in the United Kingdom, the technical nature of his interest is fixed as a matter of tax law. The nature of the beneficiary's interest under such a trust, in effect, is deemed to be a right to the income arising to the trust.

This interpretation of the case would not affect the general nature of the beneficial interest under a trust; it would be of use purely in order to determine the nature of a beneficiary's interest under a trust constituted and domiciled in the United Kingdom for any purpose of the taxing Acts. The interpretation would be compatible with the decision in Archer-Shee v. Garland, it would do no violence to equitable principles and, as a rule of income tax law, would apply equally in Scotland and England. It is submitted that this is the only interpretation of the decision in Baker v. Archer-Shee which will not conflict with the decision in Archer-Shee v. Garland and which will ensure that there is no disparity in the tax treatment of beneficiaries of Scottish and English trusts.[1]

It should be noted that income received by a beneficiary will invariably be treated as investment income. Although a beneficiary may be assessed to tax under Schedule D Case I in respect of the income of a trading trust, the income is not earned within the meaning of s. 530, I.C.T.A.

"Earned income", in relation to any individual means, inter alia, income charged under Schedule A, Schedule B or Schedule D which is immediately derived by the individual from the carrying on or exercise by him of his trade or profession as an individual.[2]

1. By reason of changes in the charging provisions the distinction drawn in the Archer-Shee cases between income from foreign 'securities' and foreign 'possessions' is no longer of significance; under Schedule D Cases IV and V income from either source is now assessed on an arising basis - s. 109 I.C.T.A.
2. S. 530(1)(c), I.C.T.A.

The beneficiary is not the person carrying on the trade or profession; he is the mere recipient of the profits. Of the income of a trading trust, the Lord President in Fry v. Shiels' Trustees stated:

> "Unquestionably, the profits of this business were ... earned profits, but they were earned by individuals[1] to whom they did not belong and they belonged to individuals who certainly did not earn them."[2]

2) Ascertaining the amount of income to which a beneficiary is entitled

It has been noted that a beneficiary is assessed to tax on the income arising to the trust and not on income from the trust. However, he is liable to tax only on so much of the trust's income to which he is entitled. His entitlement to the income will usually be fixed quite simply by the trust deed. He is not entitled to income which, under the terms of the trust is to be applied for the benefit of some other object or for some prior purpose. To illustrate this proposition it will be convenient here to consider the problem of trust administration expenses for the problem is inextricably associated with the difficulties in determining to what income of the trust a beneficiary is entitled.

Trust administration expenses

Consistently with the decision in Baker v. Archer-Shee, the income consumed in meeting the trust administration expenses does not affect the amount of income to which a beneficiary is entitled; the amount of income which as a matter of fact he receives might be affected, but it is his entitlement to income that is taken into account for the purposes of assessing him to tax.[3]

1. A Freudian slip. The other judges who heard the case did not consider the earning trustees as 'individuals'.
2. (1914) 6 T.C. 583, at p. 589.
3. It will be recalled that the Crown in Baker v. Archer-Shee withdrew the claim to tax the income used in paying the trustees expenses in New York: supra, at p. 13. It would appear that had the claim been continued it would most certainly have succeeded.

Lord Greene, M.R. in Corbett v. I.R.C. provided:

> " ... where trustees are in receipt of income which it is their duty to pay over to beneficiaries, either with or without deduction of something for trustees' expenses on the way, that income is at its very inception the beneficiaries' income."[1]

However, trustees are under no duty to pay over to a beneficiary income which he is not entitled to; for instance, income which is to be applied in satisfying some prior purpose of the trust.

On the basis of the decisions in Murray v. I.R.C.[2] and Macfarlane v. I.R.C.[3] the payment of the trust administration expenses may be made a prior purpose of the trust. This would have the effect of reducing the total income to which a beneficiary is entitled.

In Macfarlane's case it was a prior purpose of the trust that income should be applied for the payment of administration expenses connected with the trust. Once these expenses had been discharged the remaining income was payable to the beneficiary. The beneficiary received the trust income net of tax and of the administrative charges. He was not chargeable to tax on his income and so reclaimed the tax paid by the trustees on the entire income of the trust.

It was held that the beneficiary could claim back the tax which was paid by the trustees on the amount of income to which he was entitled under the trust. He could not therefore claim back the

1. (1937) 21 T.C. 449, at p. 460. The Master of the Rolls appeared to have accepted the rule in Baker v. Archer-Shee as affecting the general nature of a beneficiary's interest under a trust and not merely as a rule to be applied for the purposes of the Income Tax Acts. His statement was used to contrast the nature of the beneficial interest under a trust with that in an unadministered estate.
2. (1926) 11 T.C. 133.
3. (1929 14 T.C. 532.

tax paid in respect of the income consumed in meeting the trust administration expenses.[1]

On the basis of the Murray[2] and Macfarlane cases it is noted in Simon:

> "The trustees' expenses and authorised management fees, therefore, are paid out of the taxed income of the trust, and no relief can be claimed by trustees or beneficiaries in respect thereof. In other words such expenses grossed-up at the basic rate are a charge upon the gross income of the trust."[3]

Thus if in Macfarlane's case the trust income was £500 and the trust expenses were £100, the charge on the gross income of the trust by reason of the prior purpose would be $100 \times \frac{100}{70} = £142.86$. The gross income of the beneficiary would therefore be 500 - 142.86 = £375.14.

It is of no consequence who actually pays the trust administration expenses; the vital factor is from whose income the expenses are met, and, so far as the beneficiary is concerned, this turns upon his entitlement under the trust deed; as Lord Blackburn stated:

> "Trustees are always entitled to charge the expenses of administration against the trust estate. The question whether these expenses are to be paid out of income to which the beneficiary under the trust is entitled or out of income to which he has no right may come in almost every case to be a question depending on the construction of the trust deed.[4]

In consequence there are certain tax planning measures which may be considered in drafting a trust instrument.

1. It is a long established rule that in computing a trustee's total income for the purpose of calculating his liability to tax, no deduction may be made in respect of the expenses incurred by him in the administration of the trust - Aikin v. Macdonald's Trustees, (1894) 3 T.C. 306.
2. The facts in Murray's case were indistinguishable from those in Macfarlane v. I.R.C. In the first mentioned case it was held that the beneficiary was entitled to the income of the trust net of tax paid by the trustees and of the administrative expenses. In the light of Baker v. Archer-Shee it is clear that Murray's case no longer represents good law; see Tiley, Revenue Law, 2nd ed., at 17:22.
3. 3rd ed., E6.311(b).
4. (1929) 14 T.C. 532, at p. 540.

In respect of a beneficiary who pays no tax it would be advantageous if he were entitled to the entire income of the trust; the trustees being reimbursed for their expenses by the beneficiary personally. The beneficiary would be entitled to reclaim the tax paid by the trustees on the entire trust income.[1]

However, in respect of higher rate tax paying beneficiaries it would be desirable to insert in the trust deed a prior purpose for the payment of the administration expenses. By doing so the income consumed in meeting the expenses would be taxed in the hands of the trustees at the basic rate. Otherwise that income would be treated as the income of the beneficiary and accordingly would suffer tax at his higher rates.[2]

DISCRETIONARY AND ACCUMULATION TRUSTS.[3]

The taxation of discretionary and accumulation trusts involves to a great extent the recognition of the trust as an entity. The machinery for taxing these trusts is provided by statute, namely, ss. 16 and 17, Finance Act 1973.

Ss. 16 and 17 represent an attack on the practice of exploiting the trust as a tax shelter under which income is accumulated in the hands of trustees at a low rate of tax, the accumulated income being distributed among the beneficiaries at a later date in the form of capital payments. This process of capitalizing income (commonly referred to as 'alchemy') has been made less advantageous;

1. "Taxation of settlements": (1977-78) 100 Taxation 72, at p. 72 (Whitehouse).
2. Tolleys Tax Planning 1980, at p. 388-389.
3. Unless otherwise stated, references in this discussion are to the Finance Act 1973.

the Finance Act 1973 imposes the additional rate of tax of 15% on the income as it is accumulated in the hands of the trustees.[1] In effect, the income of the trustees is charged to tax at the rate of 45%. An income tax advantage will now be gained only where the prospective beneficiaries have personal rates of tax in excess of 45%.

The discretionary or accumulation trust is recognised as a true fiscal intermediary and is taxed as such: s. 16 operates in respect of the income of the trust, whereas s. 17 is concerned with payments from the trust.

1) Taxation of the income of the trust

Trustees of discretionary or accumulation trusts are assessed to tax under the Schedule appropriate to the source of their income. It must be appreciated that s. 16 does nothing more than to alter the rate at which trustees may be charged to tax in respect of certain income; it does not affect the actual basis of their liability. S. 16(1) provides:

> "So far as income arising to trustees is income to which this section applies it shall, in addition to being chargeable to income tax at the basic rate, be chargeable at the additional rate.[2]

1. Trustees, not being 'individuals', would not otherwise have been liable to tax at the additional rate: s. 32, Finance Act 1971 operates only in respect of individuals; supra, at p. 3-4. It was estimated that the imposition of the additional rate of tax on the income of trustees of discretionary and accumulation trusts would yield an extra £5 million in the year in which the provisions were introduced: (1973) 91 Taxation, at p. 378.
2. It is not a condition precedent to the charging of the trustees to tax at the additional rate that the income must also be charged at the basic rate: as Slade, J. indicated: " ... the phrase 'in addition to being chargeable to income tax at the basic rate' has no further function than to make it clear that the charge to income tax at the additional rate is not to supercede the charge if any, to tax at the basic rate.' - I.R.C. v. Regent Trust Co. Ltd., [1980] S.T.C. 140, at p. 148-149.

The income on which the additional rate is to be charged under s. 16(1) is described in s. 16(2). S. 16(2) provides:

> "This section applies to income arising to trustees in any year of assessment so far as it -
>
> (a) is income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it); and
> (b) is neither (before being distributed) the income of any person other than the trustees nor treated for any of the purposes of the Income Tax Acts as the income of a settlor; ..."

Excluded from the operation of the section is income which arises under a trust for charitable purposes,[1] and income which is applied in defraying the expenses of the trustees in a particular year of assessment.[2]

Thus income of a discretionary or accumulation trust is charged to tax at the additional rate if, before being distributed, it is not the income of any person other than the trustees for the purposes of the Income Tax Acts. It is suggested in Whiteman and Wheatcroft that words 'before being distributed' as used in s. 16(2) can be read as 'while still in the hands of the trustees.'[3]

Apart from the provisions of the Income Tax Acts which might operate to treat as the settlor's income arising under a trust, there are several situations in which income, while in the hands of trustees, may form part of the total income of another. In particular, in the case of a beneficiary who is sui juris and who could if he so desired terminate the trust, any income arising from the trust fund is treated as the income of the beneficiary although it remains in the hands of the trustees: this is the proposition in Hamilton-Russell's Executors v. I.R.C.,[4] a case which deserves some attention.

1. S. 16(2)(c).
2. S. 16(2)(d).
3. Income Tax, at 17:02.
4. (1943) 25 T.C. 200.

In 1918, the settlor settled funds on trustees upon trust to accumulate. On the death of the settlor the trustees were to hold the funds and the accumulation of income therefrom for such son or daughter 'as being in tail male by purchase of the freehold hereditaments settled by the Indenture of Resettlement dated 3rd day of October 1906 of the Brancepath and Baysdale Estates shall first attain the age of 21 years.'

G. L. Hamilton-Russell became tenant in tail male by purchase of the relevant estates; he attained his majority in 1928 at which time the settlor was still alive. In 1928 he was in a position to terminate the trust. Although the settlement was not due to end until the death of the settlor, G. L. Hamilton-Russell, being sui juris and the sole beneficiary had power under the rule in Saunders v. Vautier[1] to demand that the trustees should hand over the trust fund and accumulations of income to him. The rule in Saunders v. Vautier was succinctly stated by Vice Chancellor Page-Wood in Gosling v. Gosling:

> "The principle of this Court has always been to recognise the right of all persons who attain the age of twenty-one to enter upon the absolute use and enjoyment of the property given to them by will, notwithstanding any directions by the testator to the effect that they are not to enjoy it until a later age - unless, during the interval, the property is given for the benefit of another. If the property is once theirs, it is useless for the testator to attempt to impose any fetters upon their enjoyment of it in full so soon as they attain twenty-one."[2]

In fact G. L. Hamilton-Russell postponed the exercise of this right to terminate the trust. The trustees continued to accumulate until the tax year 1938-1939, and only then did the beneficiary call for payment of the funds and accumulated income. The accumulated income amounted to £14,530. The question arose as to sur-tax on that accumulated income.

1. (1841) 49 Eng. Rep. 282.
2. (1859) 70 Eng. Rep. 423, at p. 426. The rule applies equally in the case of an intervivos settlement. A similar rule exists in Scotland - Miller's Trustees v. Miller, (1890) 18 R.301.

Sur-tax could be charged only on the amount of the income which was accumulated as the income of the beneficiary and not of the trustees alone. It was necessary to determine to whom the income belonged from 1928 until the settlement was terminated in 1938.[1] According to Luxmore, L.J.:

> " ... in the present case, neither G. L. Hamilton-Russell nor the trustees of the settlement could, after G. L. Hamilton-Russell attained his majority, have insisted on the continuation of the trusts. The trustees could at any time after the happening of that event, even though G. L. Hamilton-Russell had requested them to continue the accumulation, have refused to do so, and, if he had refused to accept a transfer of the trust funds, could have paid them into Court; just in the same way as G. L. Hamilton-Russell could, contrary to the wishes of the trustees, have insisted on a transfer to himself of the whole of the trust funds. The reason why the trusts then became unenforceable and ineffective is because the funds were at home and belonged solely to the beneficiary for his own absolute use and benefit. The capital and income were his and no one else was interested in them: if the income was left in the hands of the trustees, and they invested it, they only did so by sufferance of the beneficiary whose income it was."[2]

Thus, consistently with the dicta of Luxmore, L. J., once a beneficiary becomes sui juris and can put an end to the settlement, the income (while in the hands of the trustees) is that of another person, namely, the beneficiary, and so the additional rate of tax cannot be charged on the income of the trustees under s. 16(1) despite the fact that the trustees continue to accumulate in compliance with the trust instrument. On the basis of Hamilton-Russell's Executors v. I.R.C. it is stated in Simon:

1. The Crown, however, conceded that an additional assessment could be made only on the income accumulated in the period from 6th April, 1938, to 18th Janaury, 1939.
2. (1943) 25 T.C. 200, at p. 208.

"If a beneficiary is absolutely and beneficially entitled to the income of a trust, it forms part of his total income. If the settlement directs that such income is to be accumulated, the trust for accumulation is ineffective, if the beneficiary has attained the age of eighteen, and the income will be his, even if he allows it to remain in the hands of the trustees in accordance with the directions in the settlement."[1]

In general, the additional rate cannot be charged in respect of income arising under the trust which remains in the hands of the trustees but in which a beneficiary has a vested interest. This is so even though by reason of his infancy the beneficiary is unable to give a good receipt for his income.[2] However, in respect of income in which a beneficiary has a mere contingent interest the trustees may be assessed to tax at the additional rate; the income is theirs and no-one elses.[3]

It would appear that the distinguishing feature of a vested interest is that the income in which the interest subsists immediately forms part of the beneficiary's estate. On the death of the beneficiary the accumulated income passes to his legal personal representatives. The distinction was demonstrated by Lord Greene, M. R. who compared the position of an infant with a vested interest but who cannot give a good receipt for his income with that of an infant who is entitled to income contingently upon attaining his majority.

"Apart from any special provision in the instrument under which an infant derives his interest and apart from statutory provision, an infant who has a vested interest in possession is the person entitled to the income. It is his income although he cannot give a good receipt for it. On his death under [eighteen], income which has accumulated during his minority goes to his legal personal representatives. In such a case there can be no doubt that the income accruing during minority is the income of the infant. He is accordingly chargeable with [income tax] in respect of it ... If, on the other hand, the infant is only entitled contingently on his attaining [eighteen], he has no title to any income until that event takes place. If the event does take place, he becomes entitled to future

1. E6.31.
2. The income is nevertheless that of the beneficiary - I.R.C. v. Blackwell, (1924) 10 T.C. 235.
3. See generally Simon, E6.312-314.

income and (in appropriate circumstances) to accumulations of past income. But that past income was not his in the years in which it accrued, and no one suggests that he could be assessed to [income tax] in respect of it."[1]

Stanley v. I.R.C. (the case before Lord Greene, M. R.) serves to illustrate the distinction. A testator appointed land upon trust. On the death of the testator, his son became the equitable tenant for life in possession. The testator died while his son was an infant. The son attained his majority some five years after the death of his father. In the absence of contrary intention in the testators will, s. 31 of the Trustee Act 1925 applied to the income during the son's minority.

S. 31 of the Trustee Act 1925 directs that where trust property is held by trustees for a beneficiary with a vested or contingent interest, during the infancy of that beneficiary the trustees may pay the income from trust property for the maintenance, education or benefit of him. Any surplus income is to be accumulated by the trustees and the accumulations are to be held for the beneficiary absolutely on attaining his majority.

Surplus income from the settled property was accumulated and accordingly paid to the beneficiary on his attaining the age of twenty-one years. The beneficiary was assessed to sur-tax in respect of the surplus income accumulated by the trustees. The assessment failed; the interest of the beneficiary in the income during the years of accumulation was contingent. S. 31 of the Trustees Act 1925 has the effect of transforming the beneficiary's vested interest into a contingent interest; had the beneficiary died before attaining his majority the accumulation of surplus income would not have passed to his personal representatives. The income accumulated prior to the beneficiary attaining his majority was not his income in the years in which it accrued.

1. Stanley v. I.R.C., (1944) 26 T.C. 12, at p. 17-18.

Income accumulated according to the terms of s. 31 of the Trustee Act 1925 becomes comprised in the capital of the settlement. If therefore, the interest of the infant beneficiary in the income of the trust would have been vested but for s. 31, and his interest in the capital of the trust is vested, then it follows that the income as it accumulates forms part of the total income of the beneficiary. This is because the income would fall into the beneficiary's estate by reason of his vested interest in the trust capital. Wylie noted:

> "Where an infant beneficiary has a vested interest in income and an absolute entitlement to capital even if he dies under eighteen, the trust income being accumulated during his minority should remain his income for tax purposes."[1]

Income will be treated as that of the beneficiary only if his entitlement to that income after it has arisen is indefeasible. However, the possibility that a beneficiary may not be entitled to future income arising under the trust does not affect his interest in the intermediate income as being vested and indefeasible.[2]

It would appear that s. 16(2)(b) was provided in order to prevent a charge to tax at the additional rate on trust income where that same income is taxed in the hands of the beneficiary at his personal rate. Obviously, in these circumstances there could be no exploitation of the trust as a tax shelter; the mischief at which the provisions are aimed would not be present.

2) Taxation of payments from the trust

S. 17(1) provides an elaborate scheme for the taxation of payments from discretionary trusts which are treated as income in the hands of the recipient beneficiary. In effect, the section provides the machinery by which the additional rate of tax paid by the trustees under s. 16(1) may be recovered.

1. "Capital Transfer Tax - Interests in Possession": (1980) 106 Taxation 307, at p. 310. Also Simon, E6. 312.
2. Brotherton v. I.R.C., [1978] S.T.C. 201. Cf. Cornwell v. Barry, (1955) 36 T.C. 268.

a) Payments to which s. 17 applies

S. 17(1) provides:

> "Where, in any year of assessment, trustees make a payment to any person in the exercise of a discretion exercisable by them or any person other than the trustees, then, if the sum paid is for all the purposes of the Income Tax Acts income of the person to whom it is paid (but would not be his income apart from the payment), the following provisions of this section shall apply with respect to the payment in lieu of section 52 or 53 of the Taxes Act."

Thus, a payment to which s. 17 applies (a) must have been made in exercise of a discretion; (b) must form income in the hands of the recipient beneficiary; and (c) must not have been the beneficiary's income apart from the payment.

It will be noted that there is no requirement to the effect that the payment must have been made out of the income of the trust. The section applies equally to payments out of capital which form income in the hands of the beneficiary.[1]

The effect of s. 17 is to oust the operation of ss. 52 and 53, I.C.T.A.; hence it is axiomatic that the beneficiary falls to be taxed on the payment under Schedule D Case III (ss.52 and 53 provide the machinery for the deduction of tax at source in respect of annuities and other annual payments on which the recipient will be charged to tax under Schedule D Case III).

The conditions precedent to chargeability under Schedule D Case III must therefore be satisfied in respect of the payment if it is to be treated favourably under s. 17; the payment must have been made under an obligation[2] and must be capable of recurrence.[3] Both these conditions of chargeability present difficulties in relation to payments from discretionary trusts.

1. See Brodie's Will Trustees v. I.R.C., (1933) 17 T.C. 432
2. Smith v. Smith, / 1923 / P. 191.
3. Moss' Empires, Ltd. v. I.R.C., (1937) 21 T.C. 264.

Where trustees have an absolute discretion to pay sums to the objects of a discretionary trust, unless the trustees exercise their discretion in favour of a particular beneficiary, he is entitled to nothing.[1] By the very nature of an absolute discretion it is difficult to appreciate how payments to a discretionary object are either made under an obligation or are capable of recurrence.

However, it is generally accepted by the courts that the exercise of an absolute discretion is not a voluntary act but is in a sense obligatory. Trustees are usually obliged by the terms of their trust to consider whether or not to make a payment, and it is this obligation to consider that removes the voluntariness of the operation.[2]

Finlay, J. in Lindus and Hortin v. I.R.C. refused to distinguish a payment made by trustees in exercise of a discretion from a payment made pursuant to a direction contained in the trust instrument:

> "I think that where you get the relationship of trustee and cestui que trust, where you get payments which constitute income of the recipient, then it matters not whether the payments were made, because the trustees were directed by their will to make them, or whether they were made pursuant to the discretion they exercised; once made and made to the cestui que trust, they become, in the circumstances, income of the cestui que trust; ... "[3]

In Cunard's Trustees v. I.R.C.[4] a testatrix by her will settled her residuary estate upon trust to pay the income therefrom to her sister. Clause 10(b) of the will provided:

> "If in any year the income of my residuary estate shall not be sufficient to enable my sister to live at The Grove in the same degree of comfort as she now lives there with me then I empower my Trustees to apply such portion of the capital of my residuary estate by way of addition to the income as they in their absolute and uncontrolled discretion may think fit moreover any capital so applied shall not be replaced out of the income of a subsequent year but shall be treated as an additional bequest to my sister."

1. Snell's Principles of Equity, 27th ed., at p. 134.
2. Cunard's Trustees v. I.R.C., (1945) 27 T.C. 122.
3. (1933) 17 T.C. 442, at p. 448.
4. (1945) 27 T.C. 122.

Payments were made in exercise of the discretion granted by clause 10(b) of the will. The payments were assessed to tax under Schedule D Case III. It was argued that the payments of capital by the trustees were not paid under any obligation, and that they were not capable of recurrence so as to be chargeable under Schedule D Case III.

As to the voluntariness of the payments, Lord Greene, M. R. stated:

> "They were not voluntary in any relevant sense, but were made in the exercise of a discretion conferred by the will out of a fund provided for the purpose by the testatrix. It is true, of course, that the trustees had an absolute discretion whether to make a payment or not. But the question whether they should do so is one which they were bound to take into their consideration. They could not refuse to consider whether the income of the estate was sufficient to give [the beneficiary] the required degree of comfort, and the fact that, after examining that matter, they might come to the conclusion that it was sufficient, and so decline to make a payment out of capital, does not, in my opinion, give to a payment, if and when made, the character of a voluntary payment in any relevant sense."[1]

Lord Greene, M. R. further found that the payments were capable of recurrence for the purpose of an assessment under Schedule D Case III:

> "It is sufficient, to use the language of Lord Maugham, if it has "the quality of being recurrent or being capable of being recurrent" - Moss' Empires, Ltd. v. I.R.C., 21 T.C. 264, at page 299. It is quite clear that a payment under clause 10(b) of the will is one that is capable of recurrence, because in its very nature it may be paid in any year when the income of the estate is insufficient for the purpose contemplated.[2]

A liberal approach to the problem of recurrence was criticised by Lord Radcliffe in his dissenting judgement in I.R.C. v. Whitworth Park Coal Co., Ltd.:

1. Ibid., at p. 133-134. See also Earl Loreburn in Drummond v. Collins, (1915) 6 T.C. 525, at p. 539. Lord Wrenbury in Drummond's case suggested that payments in exercise of a discretion are not voluntary in the sense that once the discretion is exercised the trustees are bound to make the payment thereafter; at p. 540-541.
2. (1945) 27 T.C. 122, at p. 133.

"The word "annual" has not been found to admit of any significant interpretation. To the Courts it means no more than "recurrent": see for example, Moss' Empires, Ltd. v. I.R.C. ... or even "capable of recurrence". That may be so, but I think that it would be both bad logic and bad law to deduce that merely because a payment is in fact recurrent or capable of recurrence it is therefore to be treated as an annual payment."[1]

Lord Radcliffe suggested that occasional payments which may in fact be capable of recurrence are more properly assessed under Schedule D Case VI. However, if occasional payments from trustees were assessed to tax in the hands of a beneficiary under Schedule D Case VI, then s. 17 would be of little effect. It could not apply in lieu of ss.52 and 53, I.C.T.A. for those sections operate only in respect of income assessed to tax under Schedule D Case III.

Exactly in what circumstances an occasional payment to a discretionary object will constitute a non-taxable capital sum in the hands of the recipient is uncertain. A payment in exercise of an absolute discretion will invariably be capable of recurrence according to the dicta in Cunard's Trustees v. I.R.C.[2] However, a discussion on the already much debated distinction between capital and income lies outwith the scope of this work.

Assuming the sums paid by the trustees in exercise of their discretion are for all the purposes of the Income Tax Acts income of the recipient beneficiary and are assessable under Schedule D Case III, then s. 17(2) and (3) replace the machinery for the deduction of tax at source which would otherwise have been provided by ss.52 and 53, I.C.T.A.

1. (1959) 38 T.C. 531, at p. 575.
2. In s. 438(2)(b) it is presupposed that a payment from an accumulation trust can constitute a capital payment; the payment may be deemed to be income; infra, at p. 125.

b) The Machinery of taxation

S. 17(2) provides:

> "The payment shall be treated as a net amount corresponding to a gross amount from which tax has been deducted at a rate equal to the sum of the basic rate and the additional rate in force for the year in which the payment is made; and the sum treated as so deducted shall be treated -
>
> (a) as income tax paid by the person to whom the payment is made; and
> (b) so far as not set off under the following provisions of this section, as income tax assessable on the trustees."

To prevent a double taxation of the trustees, s. 17(3) provides:

> "The following amounts, so far as not previously allowed, shall be set against the amount assessable (apart from this subsection) on the trustees in pursuance of subsection (2)(b) above:
>
> (a) the amount of any tax on income arising to the trustees and charged at the additional as well as at the basic rate in pursuance of section 16 of this Act;... "[1]

There are further rights of set off contained in subsection (3) though these are of less general application.

The entire scheme seeks to tax income at the additional and basic rate whilst it is being accumulated. If the accumulated income is distributed in the form of a capital sum then the additional rate of tax paid by the trustees is irrecoverable. Where however, the accumulated income is paid to a discretionary object and forms part of the income of the recipient for income tax purposes, then the additional rate of tax paid may be recovered . A simple example will serve to illustrate the operation of s. 17.

1. Tax which has been paid at the additional rate alone in pursuance of s. 16 may be used as a set off. According to Slade, J. 'the phrase "as well as at the basic rate" appearing in section 17(3)(a) merely echoes the phrase "in addition to being chargeable to income tax at the basic rate" /as used in section 16(1)/': I.R.C. v. Regent Trust Co. /1980/ S.T.C. 140, at p. 148.

	Gross	Net	Tax
Trustees income 1979/80	500	275	225
1980/81	300	165	135
Total	800	440	360

In January, 1981, the trustees exercise their discretion and pay the entire accumulated trust income available for distribution to X.

X receives £440 from the trustees. This sum is treated under s. 17(2)(a) as a net amount corresponding to a gross amount from which tax has been deducted at a rate equal to the sum of the additional and basic rate: $440 \times \frac{100}{55} = £800$

Under s. 17(2)(a), X is treated as having paid tax on the £800 at a rate of 45%: $800 \times \frac{45}{100} = £360$. If the personal rate of tax of X is 30%, he should only have paid $800 \times \frac{30}{100} = £240$ of tax. X is therefore entitled to a tax rebate of 360 - 240 = £120. The net income of X is the sum of the distribution payment and his tax rebate which is 440 + 120 = £560 (i.e. £800 net of tax at 30%).

The trustees are liable under s. 17(2)(b) to account for the tax notionally deducted from the gross payment of £800 (i.e. £360). Against their libility under s. 17(2)(b) the trustees may set off the amount of tax paid at the additional as well as the basic rate in pursuance of s. 16. The tax which the trustees paid in pursuance of s. 16 amounted to £360, therefore their liability under s. 17(2)(b) is completely discharged.

PART 2: TRUSTS AND PART XVI, I.C.T.A.[1]

Introduction

Part XVI I.C.T.A. comprises a consolidation of anti-avoidance measures which have been introduced over the years since 1922, many of which are directed at the multifarious tax avoidance schemes which embody the trust as an essential element.

It was noted in Part 1 that a tax advantage may be gained by exploiting the trust as a tax shelter under which income may accumulate in the hands of trustees thereby suffering tax at the basic and additional rate.[2] This accumulation process would give rise to a considerable saving of income tax where, but for the trust, the income would accrue to the truster to be charged to tax at his personal rate of, say, 55%. What the truster does on constituting an accumulation trust is to effectively alienate his income; the theory is that he cannot be assessed to tax on income which is not his but accrues to the trustees of the settlement.

Prior to the introduction of the anti-avoidance provisions now consolidated in Part XVI, the advantages associated with the alienation of income were great. By reason of its flexible nature the trust represented a satisfactory means of effecting such alienation. Trusts may be made revocable or on a short term basis; the truster may retain an interest under the trust if he so desires. He may make his wife or children the objects of the trust or he may retain the power to direct how the trustees are to invest the trust fund. Within certain limits, the truster may deal with his property as he chooses and he is free to settle that property on such trusts and subject to such conditions as he thinks fit.

1. Unless otherwise stated, references in this Part are to the I.C.T.A.
2. S. 16, Finance Act 1973: supra, at p. 37 et seq.

The general effect of Part XVI is not to render offending settlements void, but merely to treat the income arising therefrom as the income of the settlor, the income being charged at the settlor's personal rate of tax. Although it is possible to express in general terms the effect of its operation, Part XVI does not represent an organised structure of taxation; what identifiable structure there is would appear to have evolved by accident rather than by design. As Walton, J. indicated:

> "The difficulty ... in discerning any consistent pattern in the various chapters of Part XVI of the 1970 Act is that they all spring from totally different origins, and thus do not in any sense represent what would obviously be highly desirable, namely a 'code', in any shape of form."[1]

Part XVI is divided into four chapters. It will be convenient here to briefly summarise the nature of each of the chapters.

Chapter I is directed towards short term dispositions. Where income is paid by virtue or in consequence of a disposition to a person other than the disponer, then if the income cannot be so paid for a period of more than six years, that income will be treated for tax purposes as the income of the disponer.

The object of the chapter would appear to be to discourage those with high personal rates of tax from effecting dispositions of their income to those with low personal rates purely for the purpose of saving tax. If such dispositions are to be tax effective then they must be capable of exceeding six years. The obligation associated with the tax advantage is substantial. Obviously the obligation presents no problem to those with high and steady levels of income; but those with lower or fluctuating levels of income must carefully balance the tax advantages associated with a disposition with the possibility that in four or five years time they may not be in a financial position to meet their obligations.

1. Ang v. Parrish, [1980] S.T.C. 341, at p. 345.

Chapter II is concerned with settlements made in favour of infant, unmarried children of the settlor. Where as a result of a settlement income is paid to an unmarried infant child of the settlor, the income is treated for tax purposes as that of the settlor. But for chapter II, a parent could, by means of a settlement, effectively utilize any unused personal allowances of his child. The rate of tax on the income of the parent would be reduced and the child could maintain itself out of its own income.

Chapter III renders ineffective for tax avoidance purposes settlements which are revocable or in which there is some interest retained for the settlor or his spouse. The purpose of this chapter is essentially the same as that of chaper I. However, included in chapter III is s. 451 which basically provides that capital sums paid to the settlor by the trustees of a settlement shall be treated as the income of the settlor. "Capital sum" includes any sum paid by way of loan or repayment of a loan.

Chapter IV provides that income arising from a settlement which is paid to any person other than the settlor shall be treated as the income of the settlor for the purposes of computing his excess liability to tax. The purpose of the chapter would appear to be to minimize the tax advantages to be gained by the creation of settlements, and to increase the tax yield.

A thorough understanding of the terms "settlement" and "settlor" is essential if the operation of Part XVI is to be fully appreciated. These terms will now be considered in detail for it is the interpretation of the words "settl ement" and "settlor" that determines the scope of Part XVI.

A) THE MEANING OF "SETTLEMENT" IN PART XVI

It must be appreciated at the outset that the term "settlement" as used in Part XVI includes in its meaning a wide range of transactions as well as the legal concept of trust as described in Appendix 1. Each chapter contains its own interpretation of "settlement", or, in the case of chapter I, "disposition".

For the purposes of chapter III and IV, s. 454(3) provides:

> "'settlement' includes any disposition, trust, covenant, agreement or arrangement, ... "

In chapter II the interpretation is provided by s. 444(2) and is the same as that provided by s. 454(3) but in addition includes any 'transfer of assets.'

Chapter I relates to disposition; "disposition" being described in s. 434(2) as including 'any trust, covenant, agreement or arrangement.' Dispositions and settlements are obviously closely related.[1]

If the various interpretations of the term were read literally virtually every transaction would be a settlement for the purposes of Part XVI. The opening of a current account with a bank would be a settlement. No doubt the settlement would be considered as revocable, the creditor having the option to close his account. The creditor would therefore be the settlor of a revocable settlement, and, by virtue of s. 446 of chapter III, any income arising to the banker by reason of his investing the sum credited would be treated as the income of the creditor for tax purposes.

Because of the curious consequences which would undoubtedly follow on a strict literal interpretation of the term "settlement", it has been attempted to narrow the scope of the transactions which fall to be treated as settlements according to the literal meaning of the word as used in Part XVI. Restricting the effect of a particular term in a statute is recognised as legitimate judicial practice.

1. According to Walton, J., 'The wording of the respective definitions in ss. 434(2) and 454(3) are quite indistinguishable.' I.R.C. v. Plummer, [1977] S.T.C. 440, at p. 458.

"General words must receive a general construction, unless there is in the statute itself some ground for restricting their meaning. The fact that general words are used in a statute is not in itself, however, a conclusive reason why every case falling literally within them should be governed by that statute."[1]

To date, two approaches to the problem of restricting the operation of the term "settlement" have been presented before the courts. It has been urged that the general words which follow the word "settlement" in s. 444(2) and 454(3) should be construed ejusdem generis with the dominant word. A second argument has been advanced to the effect that bona fide commercial transactions which involve no element of bounty are not settlements for the purposes of Part XVI.

"Settlement" and the ejusdem generis construction

To construe the general words which follow the term "settlement" in s. 444(2) and 454(3) ejusdem generis with the dominant word would be to accept that dispositions, trusts, covenants, agreements, arrangements and transfers of assets are "settlements" for the purposes of Part XVI only in so far as they share the common characteristics of those transactions which may be described as settlements according to the natural meaning of the word.

The natural meaning of the word "settlement" is somewhat imprecise; Lord Moncrieff suggested that the word, according to its familiar use at Common Law, meant 'a charging of the property of the settlor with rights constituted in favour of others!'[2] Thus, a transfer of assets if construed ejusdem generis would be a settlement only if the assets of the transferor were charged with rights constituted in favour of others.

This argument was first employed by the Appellant in Hood Barrs v. I.R.C.,[3] the facts of which were as follows. The Appellant transferred 120,000 shares to his two infant daughters in equal moieties. Subsequent to the transfer dividends amounting to £4,200 arose from the shares and were paid to the daughters of the Appellant. The Crown alleged that the transfer of shares was a transfer of

1. Halsbury's Laws of England, 3rd ed., Vol. 36, at para. 596.
2. Morton v. I.R.C. (1941) 24T.C. 249, at p. 269.
3. (1946) 27 T.C. 385.

assets and therefore a settlement according to s. 444(2). The Appellant was the settlor and the dividend income was paid to his children 'by virtue or in consequence of the settlement.' S. 437(1) of chapter II provides that in such circumstances the income must be treated for all the purposes of the Income Tax Acts as the income of the settlor. Hence, the Appellant was assessed to surtax in respect of the dividend income of his children.

The Appellant contended that the transfer of the shares did not amount to a settlement; reliance was placed on the words of Lord Moncrieff in his dissenting judgement in Morton v. I.R.C.[1] as supported by Lord Macmillan in Chamberlain v. I.R.C.[2] According to Lord Moncrieff:

> "Settlement" is ... nowhere defined in the Act, although in [s. 454(3)] it is extended to include various specified deeds and arrangements which at Common Law might or might not have been regarded as forming part of a settlement. These deeds and arrangements would, however, appear to be included only in so far as they themselves effectively operate the settlement (seeing that this remains the dominant word) ... "[3]

> "As used in the statutory Sections which require construction, I interpret "settlement" in accordance with a familiar use of the term at Common Law, as meaning a charging of the property of the settlor with rights constituted in favour of others."[4]

Lord Macmillan in Chamberlain v. I.R.C. concurred:

> "I agree with Lord Moncrieff that the settlement or arrangement must be one whereby the settlor charges certain property of his with rights in favour of others".[5]

1. (1941) 24 T.C. 259.
2. (1943) 25 T.C. 317.
3. (1941) 24 T.C. 259, at p. 268.
4. Ibid., at p. 269.
5. (1943) 25 T.C. 317, at p. 331. It should be noted that both the Morton and Chamberlain cases were not concerned with the meaning of "settlement" but with determining what property is comprised in a settlement.

The Appellant argued on the basis of these remarks that if a transfer of assets is to be a settlement for the purposes of chapter II, the actual transfer must create something in the nature of a settlement in the ordinary meaning of the word. He urged that the transfer of shares to his daughters was an outright transfer which in no way resembled a settlement and that, therefore, the assessment must fail.

The Court of Appeal rejected the Appellant's contention. Lord Greene, M. R. was of the opinion that the word "settlement" did not create a genus to which the words 'disposition, trust, covenant, agreement, arrangement or transfer of assets' must belong. The Master of the Rolls noted that a covenant need not bear any resemblance to a settlement; that it was possible to create a valid covenant without the intervention of a trustee.[1]

As to the reliance which the Appellant placed on the judgement of Lord Macmillan in Chamberlain's case, Lord Greene, M. R. had little sympathy:

> "If I may say so with the utmost respect, I cannot bring myself to believe that Lord Macmillan intended to make a suggestion as to the meaning and operation of such an interpretation clause so subversive as that which [the Appellant] argues for."[2]

In Thomas v. Marshall[3] the whole issue of the ejusdem generis construction was raised once more. The Appellant opened Post Office savings accounts for his two unmarried infant children. He paid various sums into these accounts; the payments were absolute and unconditional gifts. Interest from the accounts

1. (1946) 25 T.C. 385, at p. 400-401: see also Wrottesley, J. at p. 394.
2. Ibid., at p. 402.
3. (1953) 34 T.C. 178.

accrued to the children. The interest so accruing was income paid to them by virtue or in consequence of a settlement of which the Appellant was the settlor. It was, therefore, treated for all the purposes of the Income Tax Acts as the income of the Appellant under s. 437(1) of chapter II.

It was argued by the Appellant before the Court of Appeal that the Hood Barrs case no longer represented good law.[1] It was suggested that Hood Barrs v. I.R.C. had been impliedly overruled by the subsequent decision of the House of Lords in Lord Vestey's Executors v. I.R.C.[2] Lord Vestey's Executors v. I.R.C., like the Chamberlain and Morton Cases, was concerned with determining what property was comprised in a settlement.[3] The House of Lords overruled the decision in Morton's case and in doing so approved of the dissenting judgement of Lord Moncrieff: furthermore, the House approved of the judgement of Lord Macmillan in the Chamberlain case. Although the Hood Barrs decision was not considered in Lord Vestey's Executors v. I.R.C., the Appellant in Thomas v. Marshall urged that, in the light of the Vestey case, a transfer of assets was a settlement only where there was 'a charging of the property with rights constituted in favour of others,' and that the decision in Hood Barrs v. I.R.C. should not be followed.

The Court of Appeal dismissed the Appellant's contention and applied the decision in the Hood Barrs case. Sir Raymond Evershed, M. R. distinguished the Vestey and analogous cases:

> " ... the real question which fell to be determined in all these cases, Morton's case, Chamberlain's case and Vestey's case, was not so much: Was there a settlement within the

1. Ibid., para. 8(c) of the Case state.
2. (1949) 31 T.C. 1.
3. All three of these cases are examined in detail below at p.92-96.

particular provisions of the Act in question?, but: What was the property comprised in the settlement? and that is a somewhat different question ... I think, therefore, it would be wrong for this court to say that, as it were, by a side wind, the validity of the Hood Barrs decision has been destroyed or impeached by the observations of the noble Lords in the Vestey case."[1]

Lord Morton of Henryton surmised:

"The object of the Sub-section /̅ i.e. s. 444(2) _7 is, surely, to make it plain that in Section /̅ 437 _7 the word "settlement" is to be enlarged to include other transactions which would not be regarded as "settlements" within the meaning which that word ordinarily bears."[2]

In conclusion it must be stated that it is not possible to restrict the operation of the words 'disposition, trust, covenant, agreement, arrangement or transfer of assets' to circumstances where a person has charged his property with an interest in favour of another; the words are not construed ejusdem generis with the term "settlement".

Of all the transactions or operations which fall to be treated as settlements for the purposes of Part XVI, the most abstruse is the "arrangement". An arrangement is a settlement but nowhere is "arrangement" defined in the Act. However, the frequently cited passage of Lord Greene, M. R. in I.R.C. v. Payne serves to illustrate in a general way the meaning of the word:

1. (1953) 34 T.C. 178, at p. 196.
2. Ibid., at p. 202.

> "The word "arrangement" is not a word of art. It is used, in my opinion, in this context in what may be described as a business sense, and the question is: can we find here an 'arrangement' as so construed? ... It appears to me that the whole of what was done must be looked at ... "[1]

The Lords President (Normand) in I.R.C. v. Morton suggested that in 'order that something can be described as an arrangement it must have a certain unity in its composition.'[2]

Clearly, "arrangement" is an all-encompassing term which must catch most transactions. It has long been thought desirable that business transactions should not be subjected to the provisions of Part XVI; hence, the courts have striven to provide some form of protection for what are essentially commercial arrangements. The protection so provided operates as a limitation on the scope of Part XVI and is considered below.

"Settlements" and bona fide commercial transactions involving no element of bounty

Given that the term "settlement" as used throughout Part XVI is not restricted to its natural meaning at Common Law, and that it includes such a nebulous concept as an "arrangement", it is clear that the scope of the anti-avoidance provisions is vast. A limitation on the effect of Part XVI has been developed in the line of cases beginning with Copeman v. Coleman[3] in 1939 and ending with the House of Lords decision in I.R.C. v. Plummer[4] in 1979. The development of this limitation was somewhat chaotic and it will be demonstrated later that it now applies only to those transactions which involve no element of bounty. A review of these cases is necessary as it is essential to understand the nature of the transactions which are favoured by the limitation;

1. (1940) 23 T.C. 610, at p. 626.
2. (1941) 24 T.C. 259, at p. 271. See generally (1961) 67 Taxation 135 and 147.
3. (1939) 22 T.C. 594.
4. [1979] S.T.C. 793.

it is also of interest to note how the original proposition in Copeman v. Coleman has not so much been refined but overruled by subsequent cases.

The facts in Copeman v. Coleman were relatively simple. In 1933 a company was formed to take over the Respondent's business. The capital of the company was £1,000 and its shares were held by the Respondent and his wife. Following an Extraordinary General Meeting in 1937 the capital of the company was increased to £6,000; this was effected by creating 25 preference shares each valued at £200. The newly created shares were distributed amongst the close relatives of the Respondent; two such shares were allotted to his unmarried infant children for a consideration of £10 each.

Dividends were paid of the preference shares and the Respondent was assessed to tax under s. 437 of chapter II in respect of the dividend income paid to his children. The case was disposed of on the basis that there was an arrangement and therefore a settlement; the Respondent was the settlor and the dividend income was paid to his children by virtue or in consequence of the settlement.

As a decision on a set of facts the case is unexceptional; however, during the argument of counsel, Lawrence, J. intervened and suggested of the interpretation of the term "settlement" contained in s. 444(2):

> "Is not the limitation to be read into those words - 'not being a bona fide commercial transaction?"[1]

Nothing was expressed in the judgement of Lawrence, J. to that effect, though it is safe to assume that had there in fact been a bona fide commercial transaction the assessment would have failed.

1. [1939] 2 K.B. 484, at p. 490.

Naturally, the Respondent argued that there was a bona fide commercial purpose to the transaction in that it was commercially expedient to increase the capital of the company. The Crown, however, successfully demonstrated that this argument of the Respondent was fallacious. In reality the company received a mere £250 and it immediately distributed £1,000. Further, the unpaid capital of £190 on each of the children's shares was irrecoverable.[1] There was clearly no commercially sound purpose to the transaction and so the assessment succeeded: it can only be assumed that had the Respondent been in a position to prove that the transaction was bona fide and commercial the court would have decided in his favour.

Following the perfunctory judgement of Lawrence, J. in Copeman's case, Plowman,J. was faced with the rather more complicated facts in I.R.C. v. Leiner.[2] The Respondent's mother had loaned a sum of £34,000, interest free, to T Ltd., a firm in which the Respondent was interested. For reasons immaterial to this discussion, the loan was charged to T Ltd. as security in favour of I.C.F.C., a finance company. The Respondent's mother wished to recover the £34,000 and settle this sum on the children of the Respondent (who happened to be unmarried infants). In order to release the charge on the loan the following scheme was devised: (1) I.C.F.C. released their charge on the loan; (2) T Ltd. paid the £34,000 to the Respondent's mother; (3) she paid the sum to the trustees of the children's settlement; (4) the trustees loaned £34,000 to the Respondent, interest being charged at the rate of 6% per annum (£2,040 p.a.) and (5) the Respondent loaned £34,000 free of interest to T Ltd.

The Respondent conceded that the scheme was an "arrangement" and, therefore, a settlement of which he was a settlor. The income of the trustees (the interest received by them on their loan to the Respondent) was paid to the unmarried infant children of the Respondent settlor who was accordingly assessed to tax thereon

1. (1939) 22 T.C. 594, at p. 600.
2. (1964) 41 T.C. 589.

under s. 437 of chapter II. The Respondent resisted the assessment arguing that the whole arrangement was a bona fide commercial transaction to which Part XVI could not apply and that, therefore, the trustees' income was not provided by him as a settlor under s. 442. Plowman, J. observed:

> " ... it is common ground that it is implicit in the fasciculus of Sections of which Section [442] forms a part that some element of bounty is necessary to make the Sections apply and that a bona fide commercial transaction would be excluded from their operation: see Copeman v. Coleman ..."[1]

It should be noted that Plowman, J. accepted that not only should a bona fide commercial transaction be excluded from the operation of Part XVI but also excluded should be transactions which involve no element of bounty. The "element of bounty test" was introduced in I.R.C. v. Leiner for nowhere was it recognised in Copeman v. Coleman.

In Leiner's case the learned Judge determined that there was no bona fide commercial purpose to the transaction and that there was an element of bounty involved. This conclusion was reached simply by comparing the position of the Respondent before and after the arrangement was executed: before, he was liable to make no payments to anyone, but after, he was paying £2,040 per annum in return for which he personally derived no benefit. The position of T Ltd. was unchaged; both before and after the arrangement was executed it was the recipient of an interest free loan.

Next in the line of cases was Bulmer v. I.R.C.[2] which involved a transaction which was unquestionably bona fide and of a commercial nature. The Appellants in the case held shares in Bulmer & Lumb (Holdings) Ltd., a public company which was threatened with take-over. In order to frustrate the take-over bid the following scheme was devised. S Ltd (another public company) agreed to incorporate a subsidiary company, Y Ltd. S Ltd. made a loan (the servicing loan)

1. Ibid at p. 596.
2. (1966) 44 T.C. 1.

to Y Ltd. at a commercial rate of interest. Using this loan, Y Ltd. bought shares in Bulmer Ltd on the open market. The Appellants sold their shares in Bulmer Ltd. to Y Ltd.; the purchase price was left outstanding as an interest free loan.

With the dividends that Y Ltd. received on its shares in Bulmer Ltd., the servicing loan could be repaid. On repayment of the servicing loan the Appellants had the option to purchase all the shares of Bulmer Ltd. which would be held by Y Ltd.; the consideration for this purchase would be, in effect, the discharge of the outstanding loan between Y Ltd. and the Appellants.

The problem was that the servicing loan need not have been discharged by Y Ltd. alone; any person, including the Appellants could have repaid the outstanding amount to S Ltd. The Appellants, therefore, had it in their power to terminate the arrangement at any time and recover the shares which they originally sold to Y Ltd. together with the shares which Y Ltd. purchased on the open market by means of the servicing loan.

The Crown argued, inter alia, that the whole scheme was an "arrangement" and so a settlement within the meaning of s. 454(3). The Appellants were the settlors and they had it in their power to determine the whole arrangement by repaying the servicing loan. On the termination of the settlement the Appellant would become beneficially entitled to the property comprised in the settlement, that is the shares in Bulmer Ltd. S. 446 of chapter III provides that in circumstances such as these, the income arising from the property comprised in the settlement must be treated as the income of the settlor. In this case, that income comprised the dividends paid on the shares of Bulmer Ltd. to Y Ltd.; the income which was applied to discharge the servicing loan made by S Ltd.

Against this the Appellants argued that the scheme was a bona fide commercial transaction involving no element of bounty. It was not therefore, a settlement within the meaning of s. 454(3).

The law applicable to the case, according to Pennycuick, J. was to be found in the Coleman and Leiner cases:

> "I think that in all the circumstances my proper course is to follow what was said in the Coleman and Leiner cases without expressing any independent conclusion of my own."[1]

On the facts of the case Pennycuick, J. decided that there was a bona fide commercial transaction which involved no element of bounty.

> "It seems to me abundantly clear that the transaction between the Appellants and [S Ltd.] was indeed a bona fide commercial transaction. Again, in case that imports in any respect a different test, it is clear that there was no element of bounty as between the Appellants and [S Ltd.]... It may be that the transaction has been framed ... in such a way as to procure tax advantages to the Appellants, but that circumstance does not of itself prevent it from being a bona fide commercial transaction or import any element of bounty."[2]

Before considering the case of I.R.C. v. Plummer, it will be useful to summarize the state of the law at this stage of its development.

There was nothing expressed in the judgement of Lawrence, J. in Copeman v. Coleman to the effect that a bona fide commercial transaction is excluded from the operation of Part XVI. However, such a proposition may be implied, although it does not form part of the ratio of the case for, on the facts, there was no bona fide commercial transaction. The "implied obiter dicta" of Lawrence, J. was accepted by Plowman, J. in I.R.C. v. Leiner. In Leiner's case the "element of bounty test" was introduced to determine whether or not a transaction is a "settlement". On the facts of the case before him Plowman, J. decided that there was no bona fide commercial transaction and that there was an element of bounty involved: his remarks, therefore, must be relegated to the ranks of obiter dicta.

1. (1966) 44 T.C. 1, at p. 29.
2. Ibid., at p. 29-30.

Only in Bulmer's case was there found to be a bona fide commercial transaction which did not involve an element of bounty. In that case, Pennycuick, J. thought that he should "follow what was said in the Coleman and Leiner cases". It has been demonstrated above that what was said in the Leiner case and what was not said but could be implied in the Coleman case was strictly obiter. There was no reason why Pennycuick, J. should have felt constrained to follow the previous two cases. Nevertheless, it must be said that incorporated in the ratio of the Bulmer case is one of the two following propositions: (i) a bona fide commercial transaction is not a settlement for the purposes of Part XVI; or (ii) a transaction which involves no element of bounty is not a settlement for the purposes of Part XVI.[1]

Such was the state of the law in 1977 when Walton, J. was presented with the facts in I.R.C. v. Plummer. The material facts and mechanics of the scheme devised by the taxpayer were succinctly summarized by Walton, J.:

> "The Slater Walker Group had evolved a taxation-saving scheme which it was one of the taxpayer's duties to supervise. It was aimed at high surtax payers, and in essence was simplicity itself. HOVAS [a charity] was prepared to purchase annuities from such individuals at rates which were attractive to them. This was because, as a charity, HOVAS was thought to be able to recover the tax deducted when the surtax payer paid the annuity to it, while the surtax payer was able to deduct, or was thought to be able to deduct, the amount of the annuity from his total income for the purposes of surtax. So he would receive by way of a capital sum roughly the amount which he would have to pay, over the period of the annuity, to the charity; and, as he would be able to deduct this from his total income, he would save the surtax which he would otherwise have to pay on the amount of the annuity."[2]

The scheme was attacked on four fronts; however, in the present discussion only one is significant. It was argued that the scheme was an "agreement" and therefore a settlement within the meaning of s. 454(3). S. 457(1) of chapter IV provides:

1. See Walton, J. In I.R.C. v. Plummer, below at p. 66.
2. [1977] S.T.C. 440, at p. 447-448.

"Where, during the life of the settlor, income arising under a settlement made on or after 7th April 1965 is, under the settlement and in the events that occur, payable or applicable for the benefit of any person other than the settlor, then, ... the income shall, for the purposes of excess liability, be treated as the income of the settlor and not as the income of any other person.

"In this subsection "excess liability" means the excess of liability to income tax over what it would be if all income tax were charged at the basic rate to the exclusion of any higher or additional rate."

Obviously, if this section applied the scheme of the taxpayer would be frustrated: the theory depended upon the ability of the taxpayer to deduct the amount of the annuity for the purposes of computing his liability to surtax (i.e. tax at higher rates).

The taxpayer urged on the basis of the decision in Bulmer v. I.R.C. that, as there was no element of bounty involved, the agreement was not a settlement for the purposes of s. 454(3) and that, therefore, s. 457(1) was inapplicable. Against this the Crown argued that the agreement was a settlement. There was no bona fide commercial purpose to the transaction; the purpose was purely to avoid the payment of tax.

Faced with these contentions, Walton J. was required to interpret the judgement of Pennycuick, J. in the Bulmer case; he noted the possible rationes of the case:

"It is fair to say, I think, that he comes to no final conclusion as to whether the true test of a scheme which falls outside the definition of 'settlement' is one which (a) is a bona fide commercial transaction or (b) is one in which there is no element of bounty. In Bulmer itself both tests were satisfied."[1]

1. Ibid., at p. 457.

Walton, J. had little hesitation in adopting the "element of bounty test":

" ... however wide the statutory language in which the term 'settlement' is defined, the overriding idea is that of bounty of some description. If there is no bounty, then there is nothing which can even remotely be classed as a settlement with a settlor."[1]

In the Court of Appeal, Buckley, L. J. concurred with the opinion expressed by Walton, J.:

"In my opinion it is clear from the judgements of Pennycuick J. in Bulmer v. Inland Revenue Comrs and of Plowman J. in Inland Revenue Comrs v. Leiner that those judges were there using the term 'commercial transaction' to indicate any transaction in which there was no element of bounty. It follows that a transaction effected for full consideration in money or money's worth is not a 'settlement' for the purposes of s. 457."[2]

The view of the majority in the House of Lords was clearly expressed by Lord Fraser of Tullybelton:

"In my opinion the true rule is that the definition [in s. 454(3)] applies only where there is an element of bounty. One reason is that the commercial transaction test seems to go too far; many transactions which would be generally regarded as perfectly legitimate forms of investment, are entered into solely or at least predominantly, for tax reasons, and I think it would be wrong to suggest that they might be taxable for that reason alone. But the main reason in favour of the bounty test is that the word 'settlement', even allowing for its extended definition in s. 454(3), seems to me to be used throughout Part XVI of the Act with a flavour of donation or bounty."[3]

Needless to say the taxpayer's contention was upheld.

1. Ibid., at p. 457.
2. [1978] S.T.C. 517, at p. 527.
3. [1979] S.T.C. 793, at p. 813.

Thus there is now an abundance of authority for the proposition that a transaction is a settlement for the purposes of Part XVI only if it involves an element of bounty. The proposition is substantially at variance to that impliedly propounded by Lawrence, J. in Copeman v. Coleman for it is matterless that there is no bona fide commercial purpose to the tranaction.

There was some considerable discusssion in the judgements of the House of Lords in Plummer's case as to the intention of Parliament in drafting the settlement provisions. The various sections which govern the definition of "settlement" are drafted in wide terms. Lord Wilberforce thought that it would be judicial legislation to read into the definitions an exception in favour of bona fide commerical transactions;[1] however, he had no hesitation in limiting the scope of the term to transactions involving an element bounty.[2] As Lord Diplock pointed out in his dissenting judgement, there seems to be little distinction between what Lord Wilberforce would describe as judicial legislation and what he obviously considered judicial interpretation.[3]

The dissenting judgements of Lord Diplock and Viscount Dilhorne are of particular interest. Both query the basis for limiting the scope of the settlement provisions. If it could be implied that Parliament had intended such limitations, why did it expressly include in s. 434 an exception in favour of dispositions made for valuable and sufficient consideration? Likewise, why were exceptions provided to the operation of s. 457, exceptions which are essentially in favour of business transactions?[4]

Viscount Dilhorne strenuously objected to the imposition of any limitation by the courts on the scope of the settlement provisions:

1. Ibid., at p. 800.
2. Ibid., at p. 801.
3. Ibid., at p. 810
4. See Lord Diplock at p. 809-810. The exceptions to s. 434 and 457 are discussed below at p. 97-98 and at p. 119-20 respectively.

" ... if Parliament had intended that the definition in s. 454 (3) should only apply to a settlement, disposition, trust, covenant agreement or arrangement in which there was an element of bounty, that could easily have been stated. Similarly if Parliament intended that despite the width of the definition, bona fide commercial transactions should be excluded that also could have easily been stated. For my part I decline to construe the definition as if it contained these words. It may well be that in a great many cases there will be an element of bounty but to hold, when Parliament has not so enacted, that s. 457 only applies when there is an element of bounty may be to restrict its operation far beyond Parliament's intention, and the width of the definition is a clear indication that its scope was intended to be wide."[1]

Lord Roskill in Chinn v. Collins (a capital gains tax case) advised against the acceptance of the word "bounty" as a term of art:

" ... I would venture to point out that the word 'bounty' appears nowhere in the statute.[2] It is not a word of definition. It is a judicial gloss on the statute descriptive of those cases which are caught by the section in contrast to those which are not. The courts must, I think, be extremely careful not to interpret this descriptive word too rigidly."[3]

Chinn v. Collins involved what were essentially commercial dealings with a contingent interest under a trust. The trust was constituted in 1960 and the dealings in question took place in 1969. The whole transaction was an "arrangement" which involved the appointment of the trust fund to the taxpaying beneficiary (contingent upon him surviving three days from the date of appointment). It was argued by the taxpayer that the arrangement was not a settlement in that it involved no element of bounty, the dealings with the the interest under the trust being of a commercial nature.

1. Ibid., at p. 806.
2. The statute was what is now the Capital Gains Tax Act 1979 in which for certain purposes "settlement" has the meaning given by s. 454(3) I.C.T.A. - s. 17(7) Capital Gains Tax Act 1979.
3. /‾ 1981_7 S.T.C. 1, at p. 12.

However, it was held in the House of Lords that the appointment of the fund to the beneficiary supplied the requisite element of bounty. The bounty of the settlor in constituting the trust in 1960 was incomplete. It was completed in 1969 when the absolute interest was appointed to the beneficiary, hence the arrangement was a settlement:

> "[The beneficiary] was among the objects of the 1960 settlement but before the power of appointment was exercised there was no absolute certainty, however strong the probability, that [he] would receive any of the shares held by the trustees. In my judgement there was a very real 'bounty' conferred when the trustees with the settlor's consent exercised the power of appointment in question in [the beneficiary's] favour. As counsel for the Crown put it, when the power of appointment was exercised a blank was filled in the original settlement which left blank how the final distribution of the trust's assets was to be made. That in my judgement was a clear act of 'bounty'."[1]

By reason of the decision of the House of Lords in Plummer's case, Parliament thought it necessary to prevent further exploitation of schemes such as the one devised by Mr. Plummer. S. 48 of the Finance Act 1977 basically prevents the deduction of income tax from payments specified in the section; such payments cannot be deducted in computing the total income of the payer, and no longer represent a charge on income for the purposes of corporation tax.

Subject to the exceptions in subsection (3), s. 48 applies to any payment which -

> "(a) is an annuity or other annual payment charged with tax under Case III of Schedule D, not being interest; and (b) is made under a liability incurred for consideration in money or money's worth all or any of which is not required to be brought into account in computing for the purposes of income tax or corporation tax the income of the person making the payment."[2]

1. Ibid., at p. 12 (per Lord Roskill).
2. S. 48(2), Finance Act 1977.

By this provision Parliament has effected a limited exception to the operation of the term "settlement" as construed by the courts in relation to s. 457. Because the exception is of such limited application it can only be assumed that Parliament is generally satisfied with the way in which the courts have interpreted the term. It may be implied that the decision in Bulmer's case has the approval of Parliament, for were it otherwise the legislature would have drafted s. 48 of the Finance Act 1977 in wider terms.

B) THE MEANING OF "SETTLOR" IN PART XVI

Because in Part XVI the word "settlement" is given an unnatural and wide meaning it would have been incongruous not to have provided an equally extensive interpretation of the term "settlor". It is intended here to provide an analysis of the term "settlor" and to illustrate its operation by reference to decided cases.

For the purposes of chapter II, s. 444(2) provides:

> "settlor", in relation to a settlement, includes any person by whom the settlement was made or entered into directly or indirectly, and in particular (but without prejudice to the generality of the preceding words of this definition) includes any person who has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."

S. 454(3) provides the definition of "settlor" for the purposes of chapters III and IV. The section states that "settlor", in relation to a settlement, means any person by whom the settlement was made;' and continues:

> " ... a person shall be deemed for the purposes of this Chapter to have made a settlement if he has made or entered into the settlement directly or indirectly, and in particular (but without prejudice to the generality of the preceding words) if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."

The wording of s. 444(2) differs slightly from that of s. 454(3), although the effect of the two sections in respect of the term "settlor" is the same.

Thus there are three categories of persons who are considered to be settlors for the purposes of Part XVI. There are (1) those who have made or entered into a settlement directly or indirectly; (2) those who have provided funds directly or indirectly for the purposes of a settlement; and (3) those who have made with any other person a reciprocal arrangement for that other person to make or enter into a settlement.[1] Each of these categories will now be considered in turn.

(1). "Settlor" as a person who has made or entered into a settlement directly or indirectly

This aspect of the term "settlor" may be illustrated adequately by reference to the case of I.R.C. v. Buchanan.[2] The case involved the will of Edward Cecil Guinness, the first Earl of Iveagh. The terms of the will were explained in the Case stated as follows:

> "Edward Cecil Guinness, the first Earl of Iveagh [the testator] ... died in 1927. By his will ... his residuary estate was settled upon such of his children as were living at his death and their issue. The children took a life interest with remainder as to each child's share to their issue, but any of such issue living at the testator's death took only a life interest with remainder to their issue."[3]

The will further provided:

> "Any such life tenant may at any time surrender such life interest or any part thereof to or in favour of the person or any one or more of the persons who would be entitled thereto or to some share thereof or of the trust premises in which it subsists."[4]

1. See Simon, E6.223.
2. (1957) 37 T.C. 365.
3. Ibid., para. 2(a).
4. Ibid., quoted by Lord Goddard, C. J. at p. 373.

Until 1948, A. G. (one of the testator's three children) was enjoying his life interest in possession in one third of the residuary estate. He had three daughters including L. D. L. D. herself had children.

In 1948 L. D. surrendered her contingent interest under the will, that is the interest which would have vested upon the termination of her father's interest. The day following L. D.'s surrender, A. G. surrendered his interest in the residuary estate; thereupon the interest which would have vested in L. D. had she not executed the deed of surrender actually vested in L. D.'s unmarried infant children. These children would not acquire a vested interest in possession until they attained the age of 21 years; however, the will provided that the trustees might advance to such infants sums of up to £2,000 per annum.

The object of the exercise was to save tax. The theory was that income from the residuary estate would suffer tax at a lower rate in the hands of the children than it would if paid as income to either A. G. or L. D.

The Crown sought to counter-attack the scheme. It was successfully argued before the Court of Appeal that L. D. had, by surrendering her contingent interest, effected a disposition and had, therefore, made a settlement. As the maker of a settlement she was a settlor within the meaning of s. 444(2). The sums paid by the trustees to the infant children of L. D. were paid by virtue or in consequence of a settlement of which L. D. was the settlor. The sums paid were, therefore, treated as the income of L. D. under s. 437(1) of chapter II.

It was of no consequence that the income of the infant children was in fact received from the trustees of the residuary estate and that L. D. herself paid nothing. It was also matterless that the disposition effected by L. D. on its own would not have led to any payments to her children.

The case is of importance in that it demonstrates that a person may be a settlor without actually having provided anything which forms the property comprised in the settlement or which forms the income of another person. This is of particular significance in respect of s. 437 where the source of income which is paid to the infant unmarried child of the settlor is immaterial provided it is paid by virtue or in consequence of the settlement.

(2) "Settlor" as a person who has provided or undertaken to provide funds directly or indirectly for the purposes of a settlement

Curious and rather unexpected applications of the settlement provisions result from this aspect of the term "settlor"; this is particularly so in respect of persons who provide funds for the purposes of a settlement by indirect means: Crossland v. Hawkins[1] is an example.

Crossland v. Hawkins involved a scheme commonly adopted by those engaged in the film industry and similar highly paid professions. In order to avoid a high incidence of income tax, a highly paid professional actor would form a company. He would enter into a contract of employment with the company and accept a modest salary. The company would be paid vast sums on the hiring of their employee's services. These sums would eventually reach the pocket of the employee at a later stage, perhaps upon the liquidation of the company. The employee would suffer a charge to tax on his salary though at a relatively low rate. Had he hired his services directly without the intervention of the company, obviously his income would be much greater and would, therefore, attract a higher incidence of tax.

The Respondent, H, entered into such an arrangement. On 10th December, 1954, a company was formed, R Ltd., of which H. was a director. H entered into a contract of employment with the company. Of the first two shares of R Ltd., one was held by H's accountant solely, and the other by H's wife and his accountant jointly. A trust was created on 3rd March, 1955, the settlor of

1. (1961) 39 T.C. 493.

which was H's father-in-law; the trustees were H's wife and his accountant, and the beneficiaries were, after the trustees had exercised their power of appointment, H's children who would take the trust property absolutely in equal shares should they attain the age of 25.

The trust property comprised £100, £98 of which the trustees used to purchase 98 unissued shares in R Ltd. These shares were issued on 31st March, 1955.

The company received income from the hiring of H's services and in October, 1956, a dividend of £500 was declared. Most of the income which the trustees received on their shares in R Ltd was applied to the benefit of H's unmarried infant children. The children, having unused personal allowances, claimed back the tax paid on the income which they received.

The whole scheme (that is, the formation of the company, the contract of employment and the trust deed) comprised an arrangement and was therefore a settlement.[1]

1. The Respondent unsuccessfully argued that to constitute an arrangement the whole of it must be contemplated from the outset, and that when he formed R Ltd. he did not foresee that the trustees would eventually hold the shares. It was held, however, that there was sufficient unity to constitute an arrangement. Donovan, L. J. did not "think that the language of [s. 437] requires that the whole of the eventual arrangement must be in contemplation from the very outset"; (at p. 505). On the facts of the case, Donovan, L. J. was in no doubt that there was an arrangement: "Bearing in mind the ultimate object of securing money free from the burden, or the full burden, of Surtax, can it matter for present purposes that the precise way of securing this result was not decided upon at the very outset? I think not"; (p. 505).

The Respondent was the settlor; he had provided funds for the purposes of the settlement. The contract of employment allowed R Ltd. to hire out the services of the Respondent in return for a hiring fee. By entering into the contract of employment, the Respondent was indirectly providing R Ltd. with funds. The company was part of the arrangement and so the Respondent was indirectly providing funds for the purposes of the settlement; he was, therefore, a settlor.

The sums advanced to the unmarried infant children of the Respondent by the trustees were paid by virtue or in consequence of a settlement of which the Respondent was the settlor. Accordingly those sums were treated as the income of the Respondent under s. 437.

The words "provided ... funds ... indirectly for the purpose of the settlement" as interpreted and applied in Crossland v. Hawkins are of far reaching effect. It would appear that a person indirectly provides funds for the purposes of the settlement if he does any act which causes a flow of funds into the settlement. This implies a 'causation test' to determine whether or not a person is a settlor. Difficulties may be envisaged where the act of a person is the causa sine qua non of the flow of the funds into the settlement as opposed to the causa causans; a solution to this problem is suggested below.[1]

An alternative interpretation of the case is that H was actually responsible for the entire arrangement and was therefore the maker of the settlement. The scheme was essentially devised and executed by H's solicitors and accountants; H was not specifically consulted on the matter. This did not, however, prevent H from being deemed the maker of the settlement. Pearce, L. J. noted:

1. At p.79.

> "The mere fact that [H] did not concern himself with some of the steps in the legal machinery involved does not make it any the less his arrangement within the Section. A man does not avoid the incidence of Section [437] by merely being absent from, and leaving to his solicitors and accountants, certain parts of the legal machinery, if he is aware of the proposals for an "arrangement" or a settlement and actively forwards them by personally carrying out and assisting in the vital parts in which his performance and co-operation are necessary. Nor can he avoid liability by merely giving his solicitors carte blanche to effect some scheme for the benefit of his family and refusing to concern himself with its precise form."[1]

Crossland v. Hawkins was followed by the House of Lords in the similar case of Mills v. I.R.C.[2] In Mills' case the Appellant was a child actress whose father wished to secure legal protection for her potentially vast earnings in the film making business.

A company was incorporated, S. P. Ltd., with which the child entered into a contract of employment. The scheme was as in Crossland v. Hawkins, the difference being that the shares of the company were held in trust for the child absolutely on her attaining the age of 25 years, with gift overs should she fail to attain a vested interest. The child herself was virtually ignorant of the scheme which her father had implemented. She signed the relevant documents without having read them.

S. P. Ltd. hired the services of its employee to Walt Disney Productions in return for which it received considerable sums of money. Substantial dividends were paid to the trustees in respect of the shares they held in S. P. Ltd.

It was contended by the Crown that the entire arrangement constituted a settlement; the Appellant was the settlor, and, as at the age of 25 she would become absolutely entitled to the shares in S. P. Ltd. and to the income accumulated in the hands of the trustees, she retained an interest under the

1. (1961) 39 T.C. 493, at p. 508.
2. (1974) 49 T.C. 367.

settlement. S. 447 of chapter III provides that where the settlor has an interest in the income arising under or the property comprised in a settlement, then (subject to certain limitations) any income so arising shall be treated as the income of the settlor.[1] On the basis of s. 447 the Appellant was assessed to surtax in respect of the dividends which were paid to the trustees.

Against this the Appellant argued that she was not the settlor; that the only funds provided for the purpose of the settlement were provided by S. P. Ltd.

The House of Lords had little sympathy with this argument; according to Viscount Dilhorne:

> " ... in this case it is, to my mind, taking too narrow a view of the arrangement to conclude that the funds which went to the trustees by way of dividends were just provided by /̅ S. P. Ltd. _7. To do so means shutting ones eyes to the fact that the source of the dividends was money paid for /̅ the Appellant's _7 work and money which but for the arrangement would have been received by her. In my opinion, she must be held to have provided funds for the purpose of the "settlement".[2]

The House of Lords overruled the decision of the Court of Appeal in which Lord Denning, M. R. suggested that the child actress could not have provided funds for the 'purpose' of the settlement. Lord Denning, M. R. suggested:

> "The word "purpose" connotes a mental element. The Shorter Oxford English Dictionary gives it as "intending or meaning to do something" or "the object for which anything is done". In Newton v. Commissioners of Taxation /̅ 1958 _7 A. C. 450, at page 465, it was said to mean "the end in view". According to this, in order that /̅ the Appellant _7 herself should provide funds "for the purpose of the settlement", she must have had the object - the end in view - of promoting the purposes of the settlement. For that to be her purpose, she must have had some understanding of the "arrangement" and have intended to facilitate it".[3]

1. S. 447 is considered below at p. 104 et seq.
2. (1974) 49 T.C. 367, at p. 407-408.
3. Ibid., at p. 385.

Buckley, L. J. thought along similar lines to those of Lord Denning, M. R.; however, Viscount Dilhorne disapproved:

> "I do not agree with Lord Denning M. R. that the word "purpose" in this section connotes a mental element or with Buckley L. J. that there must be a motivating intention ... I do not consider it incumbent, in order to establish that a person is a settlor as having provided funds for the purpose of a settlement, to show that there was any element of mens rea. Where it is shown that funds have been provided for a settlement a very strong inference is to be drawn that they were provided for that purpose, an inference which will be rebutted if it is established that they were provided for another purpose. In this case there is not a shred of evidence that the funds were provided for any other purpose."[1]

From the Hawkins and Mills cases it is apparent that the line which divides those who have indirectly provided funds for the purposes of a settlement from those who have done some remote act which causes a flow of funds into the settlement may be somewhat narrow and indistinct. However, a workable scheme may be extracted from the two cases, in particular from the judgement of Viscount Dilhorne in Mills v. I.R.C. Thus, a person who causes a flow of funds into a settlement is presumed to be a settlor. The presumption is rebuttable by evidence that the person did not act to benefit the settlement, but acted for some other purpose. Hence, if the act of a person is the mere causa sine qua non of the flow of funds into a settlement he is presumed to be a settlor, but he may be protected from the rigours of Part XVI by adducing evidence of the true purpose of his act, thereby rebutting the presumption. This may involve placing a heavy burden of proof on to the presumed settlor as to the purpose of his acts although this seems wholly to accord with the opinion expressed by Viscount Dilhorne.

1. Ibid., at p. 408.

(3). "Settlor" as a person who has made with any other person a reciprocal arrangement for that other person to make or enter into a settlement.

This aspect of the term "settlor" is of interest in that it appears to add nothing to the operation of either s. 444(2) or s. 454(3). This submission is demonstrable by reference to the case of I.R.C. v. Clarkson-Webb. The case involved a reciprocal agreement between two brothers. Finlay, J. detailed the relevant facts as follows:

> "The arrangement was carried out by two deeds and the substance of each deed is this: A, the first brother, appoints B, the other brother, a trustee, and covenants to pay B, for the benefit of B's infant son, a sum of £350 a year ... B, by the other deed, enters into precisely the same arrangement turned round; he makes A the trustee and covenants to pay A, for the benefit of A's infant son, the sum of £350 a year".[1]

The deeds in question were to take effect for a maximum period of 7 years.

One of the brothers was the Respondent in the case. He admitted that there was a mutual agreement. The Crown argued that the income paid to the children must be treated as the income of their respective fathers. S. 20(c), Finance Act 1922 provided that any income which, in consequence of a disposition made by any person, was payable to an infant child of that person, then if it was so payable for a period less than the life of the child, the income was to be treated as that of the disponer. "Disposition" for the purposes of s. 20 included any trust, covenant, agreement or arrangement.

The Respondent argued that as a result of the disposition made by him no income was paid to his child.

1. (1932) 17 T.C. 451, at p. 455.

Finlay, J. considered that if regard was had to one of the deeds only, then neither of the covenantors would have made a disposition for the benefit of his own child.[1]. However, he concluded that the effect of the arrangement could not be found by considering each individual deed:

> "You constantly must look at several deeds to get the true effect of an arrangement. I think one ought to look at these deeds together and, if one does, it seems to me to be reasonably plain that this was, in substance, the procuring of an arrangement by the Respondent ...
>
> "The substance of my view is this: these were dispositions; they were made by mutual arrangement; and, really, I think that they were part of an arrangement which must be looked at as a whole, with the result that they really, for this purpose, constituted one disposition."[2]

The learned Judge considered that the reciprocal arrangement amounted to an "arrangement" and therefore a disposition for the purpose of s. 20(c), Finance Act 1922. Surely such an arrangement would amount to a settlement for the purposes of Part XVI, I.C.T.A.?

It is suggested that a person who makes a reciprocal arrangement with another person for that other to make or enter into a settlement is himself making an "arrangement"; he is, therefore, a settlor by reason of his making a settlement. It can only be assumed that the "reciprocal arrangement" provisions were added to s. 444(2) and 454(3) for the avoidance of doubt.

Settlements involving more than one settlor

In the case of a settlement involving more than one settlor, the provisions of chapters II, III and IV apply to each settlor as if he was the only one.[3]

1. (1932) 17 T.C. 451, at p. 456-457.
2. Ibid., at p. 457.
3. Sections 442(1), 452(1) and 459(2). A similar provision applies to chapter I in the case of dispositions involving more than one disponer.

In general terms, the income which may be attributed to a joint settlor is limited to the amount of income originating from that settlor, or, to the amount of income arising from property comprised in the settlement to the extent that that property originated from the settlor.[1]

Income originating from a settlor includes income provided directly or indirectly by the settlor and includes income from property originating from the settlor.[2]

Property originating from a settlor includes property which the settlor has provided directly or indirectly for the purposes of the settlement.[3]

The machinery for the treatment of joint settlors may prove cumbersome in cases such as I.R.C. v. Buchanan.[4] Tiley noted that on the facts of I.R.C. v. Buchanan there was an arrangement involving A. G. and L. D. in addition to there being a disposition by L. D. alone.[5] Had the court considered that there was an arrangement, it would have concluded that there were two settlors. However, in d'Abreu v. I.R.C., the facts of which were materially indistinguishable from those in Buchanan's case, Oliver, J. refused to consider the transaction as comprising two dispositions with two settlors:

> "As it seems to me, the only enquiry which the court needs to make is whether there has been a disposition and whether it is in consequence of that disposition that the income is paid to the children of the settlor. Plainly that is the case; s. 437, it seems to me, applies; and one does not need to look at all at the provisions of s. 442."[6]

1. S. 442(2) and s. 452(2).
2. S. 442(4) and s. 452(6).
3. S. 442(3) and s. 452(5).
4. (1957) 37 T.C. 365., supra, at p. 72-74.
5. 19:19.
6. [1978] S.T.C. 538, at p. 548.

Thus, it is not open to a taxpayer to argue that a disposition made by him was a mere part of an arrangement involving others who were equally "settlors". There is, therefore, no requirement to apportion the income arising under the settlement between the various settlors; the entire income may be treated as originating from the disponer.

PART XVI AS IT APPLIES TO THE TRUST CONCEPT

Part XVI operates in respect of "settlements" and "dispositions". From the foregoing discussion it will be appreciated that both these terms encompass an extensive range of transactions including the legal concept of "trust". A trust is necessarily a settlement, but a settlement need not necessarily embody a trust.

Although it was undoubtedly the exploitation of the trust as a device for the avoidance of tax that prompted the legislature to introduce many of the provisions which Part XVI now comprises, the provisions are not specifically designed to counteract only the use of the trust as a means of tax avoidance: Part XVI catches covenants and agreements, etc. which may have none of the characteristics of "trust". Thus, nowhere is "trust" defined in Part XVI; reference is made in several of the provisions to "trustees", although there is no express recognition of the concept of the beneficiary.

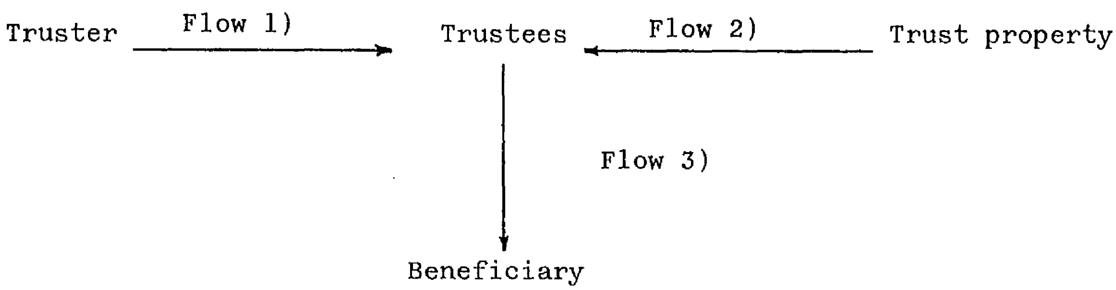
No useful purpose would be served by considering Part XVI chapter by chapter; the chapters themselves do not integrate to form any structure or scheme of taxation.[1] It is realism and not defeatism to accept that there is no structure in Part XVI which is capable of analysis.

1. Ang v. Parrish, [1980] S.T.C. 341, at p. 345 (per Walton, J.).

In general, Part XVI prescribes the circumstances in which certain income and, to a limited extent, capital is to be treated as the income of the settlor. It provides a response to circumstances rather than a positive structure of taxation of certain transactions.

In the following discussion it is intended to present an analysis of the provisions of Part XVI as they apply to the trust concept.

The concept of the trust is characterised by three flows of income. Income may flow (1) from the truster to the trustees; (2) from the trust property to the trustees; and (3) from the trustees to the beneficiary. This may be represented diagramatically thus:



Consideration will be given to the circumstances in which these various flows of income are redirected to and are treated as the income of the truster. The provisions of Part XVI can be classified to a limited extent by reference to the flows of income in respect of which they operate. Thus:-

a) s. 445 operates in respect of flow 1) in isolation.
b) s. 446 and s. 448[1] apply to income flow 2) in isolation.
c) Several of the provisions operate in respect of flows 1) and 2) without distinguishing the two. In general these provisions apply to income arising under the trust without reference to any specific source. Included here is s. 447, s. 448, s. 457 and s. 434.
d) s. 437 operates in respect of flow 3) in isolation.

1. s. 448 also operates in respect of flows 1) and 2) without distinguishing the two.

Two provisions of Part XVI which must be considered here but which cannot be classified as above in terms in income flow are s. 450 and s. 451.

If the circumstances are such that s. 450 operates, the truster may be prevented from deducting certain income payments for the purpose of computing his total income. The income is not redirected to the truster; in effect, it is treated as never having left him.[1]

S. 451 prescribes the circumstances in which payments of capital to the truster or his spouse may be treated as the income of the truster.

A) INCOME FLOWING FROM THE TRUSTER TO THE TRUSTEES - FLOW 1)

S 445 of chapter III operates in respect of income flowing from the truster to the trustees: if the section applies, the income is redirected to, and is treated as forming part of the total income of, the truster. S. 445(1) provides:

> "If and so long as the terms of any settlement (wherever made) are such that -
>
> (a) any person has or may have power, whether immediately or in the future, and whether with or without the consent of any other person, to revoke or otherwise determine the settlement or any provision thereof and, in the event of the exercise of the power, the settlor or the wife or husband of the settlor will or may cease to be liable to make any annual payments payable by virtue or in consequence of any provisions of the settlement; or
>
> (b) the settlor or the wife or husband of the settlor may, whether immediately or in the future, cease, on the payment of a penalty, to be liable to make any annual payments payable by virtue or in consequence of any provision of the settlement,
>
> any sums payable by the settlor or the wife or

1. Infra, p. 150-151.

husband of the settlor by virtue or in consequence of that provision of the settlement in any year of assessment shall be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person: ..."[1]

For the purposes of s. 445(1), references to a power to revoke or determine any provision of the settlement include references to a power to diminish the amount of payments payable by virtue of any provision of the settlement; and references to the cessation of liability of the settlor or his spouse to make such payments are deemed to include references to any diminution in the amount which the settlor or his spouse is liable to pay. However, where there is a power to diminish the amount payable under the settlement, s. 445 treats as the income of the settlor only the amount by which the payments may be diminished.[2]

Where the power to revoke or determine any provision of the settlement cannot be exercised for a period of six years from the time when the first annual payment becomes payable, s. 445(1)(a) does not apply so long as the power is not exercisable.[3] It should be noted that any deed executed subsequently which purports to extend the period over which the power cannot be exercised does not operate retrospectively. For example, assume that on 1st January, 1979 T constituted a revocable trust under which he is obliged to pay to the trustees an annual payment for a period of 15 years. The trust contains a power to revoke which is exercisable after 1st January, 1984 (i.e., 5 years after the payment of the first annual payment). On 1st January, 1981 T executed a deed, the terms of which provide that the power to revoke the trust cannot be exercised until 1st January, 1987. The deed does not, however, prevent the income payments made between 1st January, 1979 and 1st January, 1981 from being treated as the income of T under s. 445.[4]

1. Income treated as that of the settlor under s. 445(1) is charged under Schedule D Case VI - s. 449(1).
2. S. 445(2).
3. Proviso to s. 445(1). In relation to covenanted payments to charity the period is three years - s. 445(1A). What is meant by a covenanted payment to charity is considered below at p. 102.
4. See Taylor v. I.R.C., (1946) 27 T.C. 93; and I.R.C. v. Nicolson, (1953) 34 T.C. 354.

If s. 445(1) is to apply, the power to revoke or determine any provision of a trust must be found by construing the terms of the trust. If the trust is a mere integrant of an arrangement or "settlement", the power must be found within the framework of the settlement. This rule was expounded in Wolfson v. I.R.C.[1] The Respondent in the case had by deed covenanted to pay X the dividends received by him on the ordinary shares that he held in L. G. E. Ltd., a company essentially under the Respondent's control.

The Crown argued that, as the Respondent was in control of the company, he had the power to determine the settlement either by preventing the payment of dividends on the ordinary shares or by simply winding up the company; therefore, the covenanted payments should be treated as the income of the Respondent under s. 445(1)

The Crown's contention was dismissed. It was held by the House of Lords that as s. 445(1) begins, "If and so long as the terms of any settlement ... are such that - ... ", then the power must be identifiable by construing the terms of the settlement. The settlement in the case comprised only the deed of covenant, and the power of the settlor either to prevent payment of the dividends or to wind up the company could not be discovered by construing the terms of that deed.

Lord Simonds in the House of Lords recognised that the decision provided a loop hole for tax avoidance.[2] The ingenious taxpayer might avoid the provisions of s. 445(1) by arranging his affairs such that the power to determine the settlement is derived from some source extraneous to the settlement itself.

1. (1949) 31 T.C. 141.
2. Ibid at p. 169.

However, this is not quite the simple expedient that it may superficially appear to be. For instance, the incorporation of a company by A followed by the execution of a deed of covenant to pay the dividends therefrom to B, would not slip through the loop hole created by the Wolfson decision. The incorporation of the company and the execution of the deed of covenant would undoubtedly constitute an "arrangement" and, therefore, a settlement. The terms of the settlement would not be ascertainable by construing the deed of covenant alone: clearly, s. 445(1) would apply.[1]

S 445(1) is concerned with the power of any person to revoke or determine the settlement or any provision thereof; the exercise of the power must, however, extinguish any obligation to make the payments under the terms of the settlement if the section is to apply. Thus, the section has no application where the obligation to make the payments would remain unaffected by the exercise of the power even though as a matter of fact no payments would be made. The proposition is demonstrable by contrasting the cases of _I.R.C._ v. _Payne_[2] and _I.R.C._ v. _Rainsford-Hannay_.[3]

_I.R.C._ v. _Payne_ involved the following arrangement. P incorporated a company, D Ltd. of which he had full control. Approximately one year later he entered into a deed of covenant under which he agreed to pay £72 per week to D Ltd. The covenant was expressed to run during the life of the covenantor or until, in effect, such time as D Ltd. was wound up, which ever was the shorter period. The incorporation of the company and the execution of the deed of covenant comprised an arrangement which constituted a settlement of which P was the settlor. P had the power to wind up D Ltd. by virtue of his control of the company; hence, he had the power to extinguish his obligation under the covenant. S. 445(1) therefore applied and the income paid under the covenant was treated as the income of the settlor, P.

1. See Whiteman and Wheatcroft at 17:45; also _I.R.C._ v._Payne_.
2. (1940) 23 T.C. 610.
3. (1941) 24 T.C. 237.

The facts in I.R.C. v. Rainsford-Hannay were similar to those in Payne's case. A company was incorporated over which the settlor and her spouse had control. The settlor covenanted to pay the company an annuity. The covenant was expressed to run during the life of the settlor; unlike that in Payne's case, it would not have terminated on the liquidation of the company. The settlor's power over the company was not, therefore, sufficient to enable her to extinguish her obligation to make the annuity payments. It was held that s. 445(1) does not apply unless on the exercise of the power the annual payments cease to be payable. The section is not concerned with whether or not as a matter of fact the annual payments will be made. Lord Flemming stated the rule thus:

> "To bring the case under [s. 445(1)] the result of the exercise [of power] must be that the settlor or the wife or husband of the settlor will or may cease to make any annual payments payable by virtue or in consequence of any provision."[1]

Thus, income flowing from the truster to the trustees will be redirected to the truster if any person has a power to extinguish the obligation of the truster to make the payments. However, if the power is not exercisable within six years of the date of the first annual payment, s. 445(1) does not operate until the power becomes exercisable: further, the section does not apply unless the power is identifiable by construing the terms of the settlement.

B) INCOME FLOWING FROM TRUST PROPERTY TO THE TRUSTEES - FLOW 2)

S. 446 and 448 operate in respect of the income arising to the trustees specifically from trust property. S. 448 also applies to the income arising to trustees generally, however, this aspect of the provision will be considered under the appropriate heading.[2] Both sections prescribe the circumstances in which the income arising from trust property is to be treated as the income of the truster.[3]

1. (1941) 24 T.C. 273, at p. 277.
2. Infra, p. 96.
3. The income is assessable to tax in the hands of the truster under Schedule D Case VI - s. 449(1).

(i) S. 448 - the effect of a power to apply trust property for the benefit of the truster or his spouse

S. 448(1) is set out below[1] where it is considered in relation to income arising to trustees generally, without reference to any specific source of income.

The section provides, inter alia, that where trust property may be paid to or applied for the benefit of the truster or his spouse, then the income arising from that property is to be treated as the income of the truster. If part only of the trust property is the subject of the power then it is the income arising from that part which may be treated as the income of the truster. This is subject to the exemptions and proviso to s. 448(1) which, to avoid repetition, are discussed fully later.

(ii) S. 446 - the effect of a power to revoke or determine the trust or any provision thereof

Income arising from the property of a trust is treated as the income of the truster if any person has the power to revoke or determine the trust or any provision thereof, on the exercise of which the truster or his spouse will become beneficially entitled to that property. S. 446(1) provides:

> "If and so long as[2] the terms of any settlement (wherever made) are such that -
>
> (a) any person has or may have power, whether immediately or in the future, and whether with or without the consent of any other person, to revoke or otherwise determine the settlement or any provision thereof; and
>
> (b) in the event of the exercise of the power, the settlor or the wife or husband of the settlor will or may become beneficially entitled to the whole or any part of the property then comprised in the settlement or of the income arising from the whole or any part of the property so comprised,

1. At p. 103.
2. See Wolfson v. I.R.C., (1949) 31 T.C. 141; supra, at p. 87.

> any income arising under the settlement from the property comprised in the settlement in any year of assessment or from a corresponding part of that property, or corresponding part of any such income, as the case may be, shall be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person: ... "

References to a power to revoke or otherwise determine a settlement or any provision thereof include references to a power to diminish the property comprised in the settlement, and to a power to diminish the amount of payments payable under the settlement to any person other than the settlor or his spouse.[1]

If the power cannot be exercised for six years from the date that the particular property first became comprised in the settlement, s. 446(1) does not apply so long as the power cannot be exercised.[2]

A settlement may be determined by the advancement of the entire settled property. In I.R.C. v. Countess of Kenmare[3] trustees had the power to advance trust property to the settlor. The maximum value of trust property that the trustees could advance in any three years was set at £60,000. If the property actually advanced fell short of £60,000, the amount by which it fell short could be carried forward to the next triennial period. There was no doubt in the minds of the Law Lords that the trustees might have had in the future the power to advance the entire trust property to the settlor, and that such a power was a power to determine the settlement. The income arising from the trust property was therefore treated as the income of the settlor under s. 446(1).

The root problem connected with both s. 446 and s. 448 lies in determining what property is comprised in a settlement. Trusts themselves present no real difficulty. The problems arise where the trust is a mere part of an arrangement which comprises a "settlement", in which case it is essential to distinguish the settlement itself from the steps taken in its composition.

1. S. 446(2). This provision was introduced as a result of the decision in I.R.C. v. Saunders, (1957)37 T.C. 416, in which a power to diminish the property comprised in a settlement was held not to be a power to determine the settlement. See Monroe: "The Settlement Provisions of the Finance Act 1958",[1958]B.T.R 266.
2. Proviso to s. 446(1).
3. (1957) 37 T.C. 383.

The meaning of "property comprised in a settlement"

The formula for determining what property is comprised in a settlement was expounded by the House of Lords in Chamberlain v. I.R.C.[1] Chamberlain's case involved an extremely complicated arrangement the first stage of which was completed on 20th December, 1935, with the incorporation by the Appellant of S Co., an unlimited company. The company had a share capital of £100,000 comprising 50,000 preference shares of 10s. each, and 7,500 ordinary shares of £10 each. On 23rd December, 1935, the Appellant sold his shares in C. S. Ltd. to S Co.; the purchase price was satisfied partly by the transfer by S Co. of 35,000 of its preference shares to the Appellant.

On 10th March, 1936, the Appellant executed a deed of settlement under which he paid to the trustees £3,500. The trustees invested this sum in the purchase of 350 ordinary shares in S Co. Under the terms of this settlement there was the possibility that the Appellant's wife might have become beneficially entitled to the trust property such that the income arising therefrom would be treated as that of the settlor under s. 446(1).

At an Extraordinary General Meeting of S Co. held on 3rd December, 1936, the following rearrangement was sanctioned:

> " ... 7,500 ordinary shares of [S Co.] were divided into 350 "A" ordinary shares of £10 each (these being the 350 ordinary shares held by the trustees of the settlement dated 10th March, 1936); 1,750 "B" ordinary shares of £10 each ; 1,750 "C" ordinary shares of £10 each; 1,750 "D" ordinary shares of £10 each, and 1,900 "E" ordinary shares of £10 each. Voting rights were not altered. Each class of shares was entitled only to such dividend (if any) as the company should in general meeting determine."[2]

On 7th December, 1936, four more deeds of settlement were executed by the Appellant. Under each deed he paid to the trustees £100 and directed that those sums were to be invested respectively in

1. (1943) 25 T.C. 317.
2. (1943) 25 T.C. 317, para. 5 of the Case stated.

the purchase of 10 "B", "C", "D", and "E" £10 ordinary shares of S Co.[1] The settlements were irrevocable and were in favour of the children of the Appellant. The income arising under each of the settlements was to be accumulated until the children attained the age of 21 years.[2]

Dividends were paid on the preference shares held by the Appellant and on the "B", "C", "D" and "E" ordinary shares, but not on the "A" ordinary shares. It will be recalled that under the terms of the March settlement (dated 10th March, 1936) any income arising from the property thereof would be treated as the income of the Appellant. It was assumed by the Appellant that the property comprised in the March settlement consisted of the 350 "A" ordinary shares in S Co.; hence no dividends were paid on those shares.

The Appellant was assessed to tax under s. 446(1) on the entire income arising to S Co. (apart from that actually paid to the Appellant in the form of dividends on his own preference shares). The Crown contended that the incorporation of S Co. on 20 December, 1935, the sale of shares to S Co. by the Appellant on 23rd December, 1935, the settlement of 10th March, 1936, and the settlements dated 7th December, 1936, constituted an arrangement and therefore a settlement within the meaning of s. 454(3). The "B", "C", "D", and "E" ordinary shares were redeemable on the payment of a capital sum; on the redemption of those shares the only shareholders in the company would have been the Appellant and the trustees of the March settlement. The Appellant had the power to wind up the company and on doing so the assets of the company would have passed part to the Appellant himself and part to the trustees of the March settlement. The Appellant's wife was a potential recipient of the property of the March settlement.

Hence, as the Appellant had the power to redeem the "B", "C", "D", and "E" ordinary shares and the power to wind up S Co., he had the power to determine a provision of the settlement. On the exercise

1. Ibid., para. 6 of the Case stated.
2. The income arising from these settlements would not be caught by s. 437.

of this power the Appellant's wife might have become beneficially entitled to part of the assets of the company. It was assumed by the Crown that the assets of the company (that is, the shares in C. S. Ltd.) formed the property comprised in the settlement; therefore, a substantial portion of the income of the company was treated as the income of the Appellant under s. 446(1)

The Crown's contention was dismissed. The assets of the company did not form the property comprised in the settlement. The only property comprised in the settlement to which the Appellant's wife might have become beneficially entitled was the "A" ordinary shares comprised in the March settlement. No dividends were paid on those shares hence no assessment could be made on the Appellant under s. 446(1). Lord Macmillan explained:

> "I find myself unable to agree with the Crown's contention. I accept the view that the statutory expansion of the term "settlement", which includes an "arrangement", justifies and indeed requires a broad application of [s. 446] ... but a settlement or arrangement to come within the statute must still be of the type which the language of the Section contemplates. I agree with Lord Moncrieff that the settlement or arrangement must be one whereby the settlor charges certain property of his with rights in favour of others (Commissioners of Inland Revenue v. Morton[1]...) It must comprise certain property which is the subject of the settlement; it must confer the income of the comprised property on others, for it is the income so given to others that is to be treated as nevertheless the income of the settlor. There can be no question that the deeds of 10th March, 1936, and 7th December, 1936, were settlements. Each of them settled a sum of money provided by the settlor for the application of the income for the benefit of third parties ... But none of these settlements comprised any property of [S Co.] The trust funds were invested in the shares of that company, which is a different matter. In point of fact, the whole assets of the company have never been settled at all so as to dedicate the whole of its income to any trust purpose."[2]

Thus, the formation of the company was an essential element of the arrangement, but the assets of the company never became property comprised in the settlement. It is vital to distinguish the steps

1. I.R.C. v. Morton, (1941) 24 T.C. 259, is considered below at p. 96.
2. (1943) 25 T.C. 317, at p. 331.

taken towards effecting the settlement from the settlement itself. The distinction may be appreciated by considering the simple illustration provided by Lord Romer:

> "If a man enters into a contract to buy 1,000 shares in a company with a view to settling 500 of them on his daughter and does so settle the 500 shares by deed, it may well be that consistently with Section / 454(3) / ... the settlement can be described as consisting of the contract and the deed together. But the property comprised in the settlement is the 500 shares settled by deed and not the whole of the 1,000 shares. The mere fact that the contract to buy 1,000 shares was a part of the arrangement for the settling of 500 of them, is no conceivable justification for saying that the property comprised in the settlement included the other 500, even though the settlement be regarded as consisting of the whole arrangement.[1]

The principle enunciated in Chamberlain's case was applied in Lord Vestey's Executors v. I.R.C.,[2] the facts of which briefly stated were as follows. The settlors leased certain properties, the rent from which was payable to trustees in Paris. The rent so paid was to be held by the trustees for the purposes set out in the trust deed. Under the terms of the lease the settlors had the power to withdraw any of the properties demised by giving six months notice in writing to the lessees. It was argued by the Crown that the lease was part of the arrangement and the properties demised thereunder formed the property comprised in the settlement. As the settlors had the power under the lease to recover the property, the Crown urged that the income arising therefrom should be treated as the income of the settlors under s. 446(1).

The argument was rejected by the House of Lords. The only property comprised in a settlement is property in respect of which some beneficial interest is created. In the present case that property was composed of the rent payable to the trustees and the investments and accumulated income.[3] If the settlors had exercised

1. Ibid., p. 334.
2. (1949) 31 T.C. 1. The facts in the case are stated fully below at p. 112-113.
3. Ibid., pp. 82, 89, 107-108 and 120-121.

their power under the lease they would not, therefore, have become entitled to any of the property comprised in the settlement; hence, s. 446(1) did not apply.

Chamberlain's case effectively overruled the decision in Morton v. I.R.C.[1] in which the formation of a company, the transfer of assets thereto, an allotment of shares, and the execution of various trust deeds were held to constitute an arrangement. Although beneficial interests were created in the shares alone, it was nevertheless held by the First Division of the Court of Session that the property comprised in the settlement included the assets of the company.

Morton v. I.R.C. was not a decision based on Scottish law. It involved the interpretation of a technical phrase in a taxing Act, namely, "property comprised in the settlement"; Scottish courts are, therefore, clearly bound to follow the decision in Chamberlain v. I.R.C. and not that in Morton's case.

Thus, in cases where s. 446 applies, the income arising specifically from trust property is treated as the income of the truster. This is true of s. 448, although that section may also operate in respect of the income arising under the trust in general.

C) INCOME ARISING UNDER THE TRUST FROM NO SPECIFIC SOURCE - FLOWS 1) AND 2) COMBINED

The provisions which fall to be considered here are i) s. 434, which relates to income payable to or applicable for the benefit of another by virtue or in consequence of the trust; ii) s. 448; iii) s. 447 and iv) s. 457. The latter three mentioned provisions relate to the income arising under a settlement.

i) Income which, by virtue or in consequence of a trust, is payable to or applicable for the benefit of another and which is treated as the income of the truster

1. (1941) 24 T.C. 259.

S. 434(1) of chapter I provides:

> " ... any income which, by virtue or in consequence of any disposition made, directly or indirectly, by any person (other than a disposition made for valuable and sufficient consideration), is payable to or applicable for the benefit of any other person for a period which cannot exceed six years[1] shall be deemed for all the purposes of the Income Tax Acts to be the income of the person, if living, by whom the disposition was made, and not to be the income of any other person".

A trust is a disposition for the purpose of chapter I.[2] The person to whom income will be directly payable as a result of the constitution of the trust will be the trustees. The section is concerned merely with 'any income' which, by virtue or in consequence of the disposition is payable to the trustees; it draws no distinction between income arising from trust property and income flowing from the truster.

S. 434 applies to all dispositions other than those made for valuable and sufficient consideration. What is meant by valuable and sufficient consideration was discussed in Ball v. National & Grindlays Bank Ltd.[3]

The case involved the interpretation of the words "incurred for valuable and sufficient consideration" as used in s. 52(1), Finance Act 1965. It was expressly accepted by Ungoed-Thomas, J. that those words must bear the same meaning as the words "made for valuable and sufficient consideration" as in s. 434(1)[4]. The opinion of Ungoed-Thomas, J. was expressed as follows:

1. In the case of covenanted payments to charity the period is three years; see below at p. 102.
2. S. 434(2)
3. (1971) 47 T.C. 287.
4. (1971) 47 T.C. 287, at p. 296.

" ... it seems to me that "valuable and sufficient" must be given a meaning in this tax Statute independent of any common law reluctance to consider adequacy in consideration. It was submitted - rightly, in my view - that "valuable" consideration is, as it so familiarly is in a legal context, in contrast with "good" consideration ... ; and "sufficient" goes to quantum in the sense of "adequate", or, what doubtless comes to the same thing, "fair equivalent".

This opinion was supported by Russell, L. J. in the Court of Appeal. It also may be gleaned from the judgement of Russell, L. J. that the adequacy of the consideration must be justifiable at the time of the disposition.[2]

In I.R.C. v. Plummer, the facts of which are set out above,[3] it was held that the payment of £2,480 to the taxpayer was good consideration for five annual payments of £500. This was so despite the fact that the gross annuity payments amounted to some £4,255 over the five years. Both parties to the agreement anticipated that the payments would be made net of tax and that the annuitant would be entitled to claim back the tax deducted. Also taken into account was the fact that the taxpayer would be entitled to deduct the annuity payments in computing his total income. Construed as a whole, there was no doubt that the taxpayer obtained a "fair equivalent" for his obligation to make the annuity payments.[4]

Thus, unless the trust was executed by the truster for valuable and sufficient consideration, if the income paid to the trustees by virtue or in consequence of the trust is not to be treated as the income of the truster, it must be payable for a period which is capable of exceeding six years. If according to the terms of the

1. Ibid., at p. 296.
2. Ibid., at p. 299.
3. /‾1979_7 S.T.C. 793, supra, at p. 65.
4. There was no dissent on this point.

trust the truster is liable to pay to the trustees a specified sum annually for a period not exceeding four years, those payments will be treated as the income of the truster. However, should the trustees invest the annual payments, the income arising therefrom may be receivable by them for a period capable of exceeding six years; the interest would not in such case be treated as the income of the truster under s.434.

Whether or not the income will be payable for a period capable of exceeding six years will in most instances be determined by the deed effecting the disposition or trust. Thus in I.R.C. v. The Trustees of the Hostel of St. Luke, Registered,[1] the subscriber to a charity executed a deed of covenant on 3rd February, 1927, under which he covenanted to pay to the trustees of the charity a certain sum less tax. The terms of the deed were in the following form:

> "The subscriber hereby covenants with the [charity] that he will during the term of seven years from the 6th April, 1926 or during his life (whichever is the shorter period) pay to the Funds of the [charity] annually from his taxed income the sum of ten pounds less Income Tax ... the first annual payment to be made on the 31st day of December, 1926 and subsequent annual payments to be made on the 31st day of December each year."[2]

The trustees claimed a repayment of tax in respect of these annual payments. Their claim failed. S. 434 deemed the income to be that of the subscriber for all the purposes of the Income Tax Acts. The income was payable to the trustees for a period which could not exceed six years.

In this case the liability to pay arose when the deed was excuted on the 3rd February, 1927. The final payment was to be made on 31st December, 1932 (that is, the 31st December preceding 6th April, 1933). The period over which the liability was to be discharged was from 3rd February, 1927 (the date of the disposition) to 31st December, 1932, which is a period of five years eleven months less three days. The income was payable for a period which could not exceed six years.

1. (1930) 15 T.C. 682.
2. Ibid., at p. 684-685.

The case not only illustrates the importance of the wording of the deed, but also demonstrates that where the deed imposes a liability on the truster to make payments to trustees, s. 434 is concerned only with the period over which the obligation imposed by the terms of the trust may be discharged. The obligation of the truster cannot be back-dated by the words in the deed; the liability arises only when the deed is delivered.

It would appear that the period over which the liability of the truster is capable of being discharged need not be set by reference to dates. In <u>I.R.C.</u> v. <u>Black</u>[1] the Respondents covenanted to pay L Ltd. annually a sum which was variable though calculated by means of a set formula. The covenants were to run for a period in excess of seven years, however, once one covenantor had paid an amount of £100,000, his liability would be considered discharged. Within two years of the execution of the covenants the Respondents had each paid £100,000 thereunder.

The Crown argued that, as the Respondents' liability was discharged within two years of the date of the covenants, the income paid was not payable for a period which was capable of exceeding six years. The argument was rejected at first instance and by the Court of Appeal. Lawrence, J. at first instance explained:

> "The Section does not say a period which in the events that happen does not exceed six years, but which by virtue of the disposition cannot exceed six years."[2]

Although the covenant was expressed to run for a period in excess of seven years, it is submitted that the payments would have been payable for a period capable of exceeding six years without such an express term. It may be that where the sums payable are variable according to, for example, the truster's income, then a limit may be set on the maximum amount payable by the truster; this would not prevent the liability of the truster from being discharged over a period capable of exceeding six years.[3]

1. (1940) 23 T.C. 715.
2. Ibid., at p. 719.
3. A scheme based on this principle might be vunerable in that the Revenue would doubtless argue that the payments represent a payment of capital by instalments rather than a series of income payments.

It will be appreciated from Black's case that income payable by virtue or in consequence of a disposition need not be a fixed sum; provided it is payable for a period capable of exceeding six years, the annual payment of a variable sum cannot be treated under s. 434(1) as the income of the disponer. This is subject to the rule that there must be some element of constancy associated with the variable sums. Wrottesly, J. in D'Amrumenil v. I.R.C. stated the rule thus;

> " ... the income must be payable for a period of over six years, and I think there must be some constant element in such yearly payments of income. It may be that the constant element introduced by the promise of the same fraction of a man's income for the requisite number of years would be sufficient."[1]

D'Ambrumenil v. I.R.C.concerned a covenant for the payment of £20, thereafter there was to be paid annually an amount that was equal to three-quarters of the covenantor's total income. The £20,000 was deemed to be the income of the disponer under s. 434(1); it had nothing in common with the subsequent payments.

> "In this case the £20,000 has nothing in common with the subsequent payments all of which are to be a constant fraction of the giver's yearly income; it is a sum payable for a period which cannot exceed six year, namely, one year; ...[2]

It was stressed earlier that s. 434 operates in respect of 'any income' payable to the trustees by virtue or in consequence of the trust. The cases so far discussed are relevant in relation to the flow of income from the truster to the trustees. However, income flowing from the trust property to the trustees is equally income payable 'by virtue or in consequence of ' a disposition

1. (1940) 23 T.C. 440, at p. 447.
2. Per Wrottesly, J. at p. 447. Wrottesly, J. followed the first instance decision in I.R.C. v. Mallaby-Deeley; (1938) 23 T.C. 153. In Mallaby-Deeley the covenantor had agreed to pay specified sums each year. In year 1 the sum of £5,600 was payable; the amount to be paid each year decreased until in year 7 only £700 was payable. Lawrence, J. held that the only income which was payable for a period capable of exceeding was £700, (at p. 161-162). The decision was reversed by the Court of Appeal though on the grounds that the payments constituted a payment of capital by instalments.

and must be payable for a period capable of exceeding six years it is not to be treated as the income of the truster. The principle may be illustrated by reference to the case of I.R.C. v. Prince-Smith.[1]

The Respondent wished to provide a capital sum for his children. He was the majority shareholder in P.S. Ltd., the other shares in which were held by the Respondent's wife and his father. The Respondent's father executed a trust deed; he settled £2,500 on the children. The trustees were authorised to invest the trust fund in P. S. Ltd.; they did so acquiring 50,000 ordinary shares. On 18th March, 1938, the Respondent by means of his control of P. S. Ltd. converted the 50,000 ordinary shares into preference shares with a fixed rate non-cumulative preferential dividend at a rate of 50% until 31st March, 1943; thereafter, at the rate of 5%.

It was held that an arrangement and therefore a disposition was made on 18th March, 1938. The Respondent was the disponer. According to the terms of the arrangement only a 5% dividend was payable on the trust shares for a period capable of exceeding six years. Dividends payable at the rate of 50% were payable only for the period beginning 18th March, 1938, and ending on 31st March, 1943: a period of five years and thirteen days. Any amount paid in excess of a 5% dividend was treated as the income of the Respondent.

Covenanted payments to charity

A special dispensation is made from the operation of s. 434 in respect of covenanted payments to charities. A covenanted payment to charity is a payment made under a covenant which was made otherwise that for consideration in money or money's worth. The payment must be made to a trust established for charitable purposes and must be one in a series of annual payments which

1. (1943) 25 T.C. 84.

are payable for a period capable of exceeding three years. The payments under the covenant must not be determinable within three years without the consent of the persons entitled thereto.[1] Under s. 434(1) income payable as a covenanted payment to charity is treated as the income of the covenantor only if it is payable for a period which cannot exceed three years.[2]

ii) Income arising under a trust which is treated as the income of the truster

S. 448(1) reads:

> "If and so long as the terms of any settlement (wherever made) are such that any person has or may have power, whether immediately or in the future, and whether with or without the consent of any person -
>
> a) to pay or apply to or for the benefit of the settlor or the wife or husband of the settlor the whole or any part of the income or property which may at any time arise under or be comprised in the settlement; or
>
> b) to secure the payment or application to or for the benefit of the settlor or the wife or husband of the settlor of the whole or any part of that income or property,
>
> being a power exercisable at his discretion, any income arising under the settlement[3] in any year of assessment or, as the case may be, any income so arising from the property comprised in the settlement or from a corresponding part of that property, or corresponding part of such income, shall (so far as it is not so treated apart from this section) be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person ..."[4]

1. S. 434(2)
2. S. 434 (1A)
3. "Income arising under a settlement" for the purposes of chapter III and IV includes income chargeable to tax by deduction or otherwise, or would have been so chargeable had it been received in the United Kingdom by a person domiciled and resident or orinarily resident in the United Kingdom": s. 454(1)(a) and s. 459(1).
4. Where there is a power to apply the trust property for the benefit of the truster or his spouse then only such income that flows from that property is treated as income of the truster under s. 448; supra, p. 90.

Where any person has a power to apply the income arising under a trust for the benfit of the truster or his spouse that income will be treated as the income of the truster irrespective or whether the source of the trustees income is the truster himself or the trust property.

If the power cannot be exercised within six years from the time that the income first arises under the trust, then s. 448(1) does not apply so long as the power is not exercisable.[1]

Where the power is exercisable only on the happening of one of the events mentioned in the proviso to s. 447(2), s. 448(1) does not apply.[2] The proviso to s. 447(2) is discussed below at p. 118.

<u>iii) Undistributed income of a trust which is treated as the income of the truster</u>

S. 447 reads:

> "(1) If and so long as the settlor has an interest in any income arising under or property comprised in a settlement (wherever made), any income so arising during the life of the settlor in any year of assessment shall, to the extent to which it is not distributed,[3] be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person:
>
> Provided that -
>
> (a) if and so long as that interest is an interest neither in the whole of the income arising under the settlement nor in the whole of the property comprised in the settlement, the amount of income to be treated as the income of the settlor by virtue of this subsection shall be such part of the income which, but for this proviso, would be so treated as is proportionate to the extent of that interest; and

1. S. 448(2). See <u>Taylor</u> v. <u>I.R.C.</u>, (1946) 27 T.C. 93, and <u>I.R.C.</u> v. <u>Nicolson</u>, (1953) 34 T.C. 141, supra, p. 86. In respect of income arising from trust property, the period is six years from the time the property first became comprised in the trust.
2. S. 448(3).
3. The means of ascertaining the amount of income which has not been distributed is described below at p.146.

(b) where it is shown that any amount of the income which is not distributed in any year of assessment consists of income which falls to be treated as the income of the settlor for that year by virtue of section 445 or 446 above, that amount shall be deducted from the amount of income which, but for this proviso, would be treated as his for that year by virtue or this subsection.

(2) For the purpose of subsection (1) of this section, the settlor shall be deemed to have an interest in income arising under or property comprised in a settlement if any income or property which may at any time arise under or be comprised in that settlement is, or will or may become, payable to or applicable for the benefit of the settlor or the wife or husband of the settlor[1] in any circumstances whatsoever: ... "

Subject to the provisos in s. 447(1), the undistributed income of a trust will be treated as the income of the truster if he retains any interest in either the income or property of the trust. The truster will be deemed to have an interest in the income or property of the trust where that income or property is, will or may become payable to or applicable for the benefit of himself or his spouse.

The interest may arise by virtue of an express term of the trust; however, the section applies equally to a latent interest which exists by reason of the operation of the doctrine of resulting trusts. The truster must effectively dispose of the entire beneficial interest in the trust property and income if he is to escape the effects of s. 447(1)

1. In I.R.C. v. Tennant, (1942) 24 T.C. 215, it was provided that the wife or husband of the settlor includes a potential wife or husband. However, the Inland Revenue have stated that this rule will be applied only where the settlor is unmarried or where "whether or not the settlor is married, the terms of the settlement ... are such as to indicate a specific intention that a future wife or husband of the settlor might be entitled to benefit". See Mustoe, "Settlor's wife or Husband": (1959) 109 The Law Journal 681. Wife or husband does not include widow or widower - Lord Vestey's Executors v. I.R.C., (1949) 31 T.C. 1, infra., at p. 113.

No question arises as to the application of the section should the trust fail entirely ab initio. In such circumstances the beneficial interest which has not been disposed of is simply carried back to the truster on resulting trust.[1] From the outset the 'trust income' remains the income of the truster, it is never the income of anyone else. However, where there is a partial failure to dispose of the trust property or income, the undistributed income will be treated as the income of the truster under s. 447(1). For example, assume that the terms of the trust provide that the income is to be paid to such of X and Y as the trustees in their absolute discretion think fit, subject to an overriding power of accumulation. If there is no stipulation as to the treatment of the trust income or property after the death of X and Y, that income and property will be held on resulting trust for the truster. The trust income and property will be paid to the truster should he survive X and Y; he is, therefore, deemed to have an interest in the income arising under and the property comprised in the trust, and any income arising under the trust during the life of X and Y which was not distributed will be treated as the income of the truster.[2]

S. 447(2) is drafted in particularly wide terms; where there is the possibility that either the property or the income of the trust may become payable to the truster or his spouse in any circumstances whatsoever, he is deemed to have an interest therein. The words "in any circumstances whatsoever" add considerably to the scope of the section. This may be appreciated by considering the cases of Barr's Trustees v. I.R.C.[3] and Muir v. I.R.C.[4]

1. Re Vandervell's Trusts (No. 2) [1974] 1 All E.R. 47. See also Wilson and Duncan, at p. 74.
2. For an example of the operation of the doctrine of resulting trusts and s. 447 see Hannay's Executors v. I.R.C., (1956) 37 T.C. 217
3. (1943) 25 T.C. 72.
4. (1966) 43 T.C. 368.

In Barr's Trustees v. I.R.C. the truster had settled shares in B. Ltd. on his grandchildren, Robert Barr and Archibald John Barr. The respective interests of the beneficiaries were to vest on their attaining the age of 30 years. Clause 4 of the deed provided:

> "In the event of both the said Robert Barr and Archibald John Barr dying before reaching the said time of vesting and payment without lawful issue, the Trustees shall divide the Trust Estate among the heirs and representatives in moveables of my said son."[1]

It was held by the First Division of the Court of Session that the truster himself could be included in the group of "heirs and representatives in moveables" of his son. He had, therefore, an interest in the income arising from the property comprised in the trust for the purposes of s. 447, and was accordingly assessed to tax on the undistributed income of the trust.

Muir v. I.R.C. involved a trust the terms of which provided for the capitalization of the trust income. Clause 8 of the trust instrument provided that the capitalization could be effected:

> " ... by applying the [income] in or towards payment of the premiums on any policy or policies of assurance in which any beneficiary shall (whether under this Settlement or under any other Settlement or otherwise) have any beneficial interest whether vested or contingent and whether indefeasible or defeasible."[2]

This clause was sufficient to create in the settlor an interest in the income of the trust for the purposes of s. 447. Pennycuick,J. explained:

1. (1943) 25 T.C. 72, para. 3 of Case stated.
2. (1966) 43 T.C. 468, at p. 377.

" ... the trustees, in performance of their duties under the settlement might apply income towards the payment of premiums under a policy comprised in another settlement under the terms of which the trust funds, including the policy, are held in trust for one of the settlor's grandchildren contingently upon attaining the age of 21, with a default trust for the settlor. It is impossible to say that such an application would represent a breach of trust. The application of income towards the payment of these premiums would in the first place benefit the grandchildren, but it would clearly also benefit the settlor."[1]

The decision of Pennycuick, J. was reversed by the Court of Appeal though on different grounds. Harman, L. J. acknowledged that the exercise of the trustees' power to pay the premiums on an assurance policy in which the settlor might be interested was not too remote to prevent the settlor from being treated as having an interest in the income of the trust.[2]

The decisions in Barr's Trustees v. I.R.C. and in Muir's case at first instance are a little harsh. The truster must ensure that according to the terms of the trust there is no possibility that either the trust property or income can be applied for his or his spouse's benefit. Further, if the possibility was unforseen by the draftsman of the deed, it cannot be argued that, as the truster intended the trust to be tax effective, there is an implied term to the effect that the trustees should not at any time apply the income or property of the trust for the benefit of the truster or his spouse. To imply such a term would be to presume that the draftsman of the deed was familiar with fiscal law; a presumption which is not tenable in the courts, as Stamp, L. J. declared:

1. Ibid., at p. 384.
2. Ibid., at p. 391.

"I do not think that there is any presumption that advisers of a settlor do know the fiscal law and if there are some provisions of the fiscal law which are so notorious that almost everybody knows about them, there are other provisions which are obscure and difficult and (as one may see from the decided cases) unknown to many draftsmen. If there was such a presumption where could one draw the line? The suggestion that a draftsman ought to be taken to be aware of the fiscal consequences of what he is doing and that ambiguity should be resolved on that basis is, in my judgement, a heresy and cannot be supported."[1]

In practice, s. 447(2) is not given a strict literal interpretation. It would appear that the section will not necessarily operate where there is a mere possibility that the income or property of a trust may be voluntarily applied for the benefit of the truster or his spouse; if the terms of the trust do not provide for such application, then the truster has no deemed interest under s. 447(2). In Glyn v. I.R.C.[2] the Appellant and his son executed a deed of resettlement in 1928. Prior to the resettlement property was held in trust for the Appellant for life, thereafter, to the use of his son in tail male with remainders over. The deed of resettlement had the effect of disentailing the settled property. The resettlement comprised the surrender of the Appellant's life interest and the constitution of an accumulation trust, the trustees of which were to stand possessed of the trust property upon such trusts as the Appellant and his son should appoint; in default of appointment, the income of the trustees was to be accumulated until the happening of a specified event after which the accumulated income was to be paid to the son, and the trust capital was to be held for the son and his descendants.

The Appellant conceded that, for the purposes of s. 447, the resettlement constituted a "settlement" of which he was the settlor. The Crown successfully argued before the Kings Bench Division that the settlor was deemed to have an interest under the settlement in that he had the power to direct the trustees to apply the income of the trust for his own benefit. The undistributed income of the trust was, therefore, treated as the income of the Appellant under s. 447(1).

1. I.R.C. v. Cookson, [1977] S.T.C. 140, at p. 146. Cf. I.R.C. v. Fitte, (1943) 24 T.C. 337, where the operative words of the deed failed to carry out the declared intention of the settlor. The effect of the operative words must be assessed in the light of the settlor's declared intention and the circumstances surrounding the execution of the deed: see Goddard, L.J. at p. 351.
2. (1948) 30 T.C. 321.

In Glyn's case it was matterless that the power to appoint the income was exercisable by the Appellant jointly with his son; however, it was conceded by the Crown that had the power been vested in the son alone, then the Appellant would not have had an interest in the trust income, despite the fact that the son might have appointed in favour of his father.[1]

The Commissioners for Special Purposes of the Income Tax Acts supported the view that s. 447(2) should not be interpreted strictly:

> "We accept the argument that the words "in any circumstances whatsoever" in [s. 447(2)] cannot be read as including the possibility of a mere voluntary application of income by a beneficiary to the settlor, outside the provisions of the settlement itself".[2]

There was nothing in the judgement of Singleton, J. to indicate any disapproval of the Commissioners' opinion.

In <u>Muir</u> v. <u>I.R.C.</u>, Pennycuick, J. thought it necessary to restrict the operation of the deeming provision in s. 447(2). The case concerned an ill-drawn deed of trust. Doubts as to the validity of the trust arose, and on the basis of these doubts a compromise was negotiated under which the trustees paid to the settlor the sum of £20,000 in consideration that he disclaimed any right which might have arisen by reason of a resulting trust. The compromise was sanctioned by the Chancery Division

The settlor was assessed to tax on certain income which arose under the trust prior to the date on which the compromise was negotiated.

1. Ibid., at p. 329.
2. Ibid., para. 10 Case stated.

The Crown argued, inter alia, that where at a future date the validity of a trust may be open to doubt, then there is always the possibility that the income and property thereof may in the future be held on resulting trust in favour of the settlor. It was urged that such a possibility was sufficient to invoke the operation of s. 447(1)

The Crown's contention was rejected. The mere doubt that at some time in the future the trust might be declared invalid is not sufficient to create in the settlor an interest in either the income or property of the trust for the purpose of s. 447(1). Pennycuick, J. stated:

> "Section [447] is in very wide terms, but it must, I think be confined to cases where the income or property "will or may become payable or applicable for the benefit of the settlor" either under the trusts of the settlement itself or under some collateral arrangement having legal force: e.g. the repayment of an interest-free loan, such as was considered by the Court of Appeal in Jenkins v. Commissioners of Inland Revenue[1] ..."[2]

This aspect of Pennycuick, J.'s judgement was upheld in the Court of Appeal. If in fact a doubt that at some time the trust may become invalid proves to be well founded, the Revenue will be entitled to make additional assessments on the settlor in respect of the years prior to the invalidation of the trust.[3]

Thus, if the truster is not to be treated as having an interest in the trust property or in the income arising under the trust, he must ensure that there is no possibility that as a necessary legal consequence of his constituting the trust, income or property will revert to him. The following suggestion is made in Simon:

1. (1944) 26 T.C. 265.
2. (1966) 43 T.C. 368, at p. 381.
3. The practicality of this rule is doubted by Tiley, at 19:39.

"Wide though the words "in any circumstances whatsoever" are, it seems clear, as the Crown admitted in Glyn v. I.R. Comrs. that some limit must be placed on them. If this were not so, a settlor could be said to have an interest in virtually every settlement, as the remaindermen might bequeath their beneficial interests to him by will. It may be that the limit lies at the point where the settlor can have no interest in any circumstances that are contemplated by the settlement, and has not in fact acquired any interest through extraneous circumstances. For example, it is thought that the possibility of acquiring an interest on the intestacy of a beneficiary does not give the settlor any interest in the settled property or income, at any rate unless and until the possibility has become an actuality.[1]

The meaning of the words "payable to or applicable for the benefit of" the settlor or his spouse in s. 447(2)

Controversy has arisen in respect of the operation of the words "payable to or applicable for the benefit of" the settlor in connection with loan arrangements made between trustees and trusters.

In Lords Vestey's Executors v. I.R.C.[2], the House of Lords held that a commercial loan made out of trust income or property in favour of the truster does not represent income or property paid to or applied for the benefit of the truster within the meaning of s. 447(2).
The facts in the Vestey case are briefly set out above.[3] Land was leased by the settlors. The lessees were directed to pay their rent to trustees in Paris. The rent was to be held by the trustees in trust to accumulate "until the expiry of 20 years from the death of the last surviving grandchild now living of

1. E6.238 (at p. 1068).
2. (1949) 31 T.C. 1.
3. Supra, at p. 95.

the Settlors". The trust also provided that the trustees were to invest the accumulated rent according to the direction of authorised persons: the settlors were included within the class of authorised persons.

The accumulated fund was to be held in trust for such of the settlor's children or remoter issue (and their wives and widows) as the settlors might appoint. The deed also reserved a power in the settlors to appoint the fund by will or codicil in favour of their widows. Lord Reid summarized the rights of the settlors thus:

> "After the execution of the lease ... and deed of settlement ..., the only rights relevant to the present case which the Vesteys had with regard to the moneys which came into the hands of the Paris trustees were rights to appoint certain funds to their issue, rights to appoint life interests to their widows, and a joint right to direct the investment of the settled fund."[1]

It was argued by the Crown that s. 447 applied and that the undistributed income of the trust should be treated as the income of the settlors. It was suggested that by reason of the settlors' power to direct the investment of the trust fund they had an interest in the income arising therefrom; the income might have become payable to the settlors "in any circumstances whatsoever" in that they could have directed that the trust fund should be loaned to themselves upon their personal credit: a direction which the trustees would be bound to follow.[2]

1. (1949) 31 T.C. 1, at p. 116.
2. It was also argued that the settlors' spouses were interested in the trust income in that the settlors might have appointed in their favour by will. This argument was rejected: the wife or husband of a settlor does not include the widow or widower of the settlor. This overruled the decision of the Court of Appeal in Gaunt v. Gaunt, (1941) 24 T.C. 69.

The Crown's argument was rejected by the House of Lords. The Settlors, in exercising their power to direct the investment of the trust fund would be acting in a fiduciary capacity; they would not be entitled to profit by their office.[1] If they chose to direct a loan to themselves it would be required to be at a commercial rate of interest. A loan at a commercial rate of interest would not be income paid to or applied for the benefit of the settlor within the meaning of s. 447(2). Lord Morton of Henryton explained:

> "The phrase "payable to or applicable for the benefit of" is a well known one, frequently used in settlements where money is either paid to a beneficiary who can then use it as he pleases, or is to be applied by trustees in some manner which will benefit the beneficiary. Reading the phrase as a whole I am satisfied that the words "payable to" are directed only to an out-and-out payment with no obligation on the payee to return the money. As to the words "applicable for the benefit of the settlor", I think that a loan may well benefit a person even if it is made at a commercial rate of interest, as it may tide him over a difficult period, but I do not think that if the money is so lent it is applied "for the benefit of" the debtor within /̅S. 447(2)_7[2]

Lord Vestey' Executors v. I.R.C. was considered by Goff, J. in I.R.C. v. Wachtel[3]. Consonant with the dicta of Lord Morton of Henryton in the Vestey case, Goff, J. considered that sums paid to the settlor by the trustees pursuant to a commercial agreement are not to be considered as being applied for the benefit of the settlor merely because he derives some incidental benefit from the transaction. Thus, the possibility of a loan to a settlor at a commercial rate of interest would not represent an interest of the settlor in the trust income or property for the purposes of s. 447. Burgess expressed some doubts as to the rationale of this proposition: he considered the judgement of Lord Morton of Henryton in the Vestey case and suggested:

1. See Lord Simon at p. 83-84.
2. (1949) 31 T.C. 1, at p. 114-115.
3. (1971) 46 T.C. 543. The facts of the case are presented below at p. 115.

> "It is clear from his judgement that loans, if they were to be caught at all, would be caught by the words "applicable for the benefit of" the settlor. As Lord Morton accepted that, as a matter of fact, loans could be for the benefit of settlors, even at commercial rates of interest, it is suggested that the principle is that all loans are prima facie covered by the section, but with an exception operating in favour of those at commercial rates of interest.[1]

Burgess supported his submission by reference to the judgement of Goff, J. in I.R.C. v. Wachtel.

He suggested that the position is unsatisfactory; that there is no cogent reason why s. 447 should not embrace all loans whether at commercial rates or otherwise. He argued that it would be impossible to determine whether or not a benefit is merely incidental to a commercial transaction and concluded:

> "The present writer would prefer that all loans to settlors be within the section since all loans confer benefits.[2]

Slightly different considerations arise in relation to loans by the settlor to trustees; this was the position in Wachtel's case. In I.R.C. v. Wachtel, the Respondent executed a trust deed on 4th April, 1960. The beneficiaries of the trust were the Respondent's children.

The day following the execution of the trust the trustees agreed to purchase shares in E. I. Ltd.; the purchase price was greatly in excess of the funds available to the trustees. In order to finance the deal the trustees borrowed from D. Bank Ltd. The Bank would grant the trustees overdraft facilities on condition that the Respondent would guarantee the overdraft and would deposit at the bank an amount which would cover the debt. The guarantee agreement was made on 22nd March, 1960, (before the execution of the trust).

1. "The Settlor and Section 447": /‾1971_7 B.T.R. 278, at p. 281.
2. Ibid., at p. 282.

It was agreed that the bank would charge interest on the trustees' overdraft at a rate of 1%, but it would pay no interest on the sum deposited as security by the Respondent. It was further agreed that the trustees would pay the trust income to reduce their overdraft and that the Respondent could reduce his deposit accordingly.

The trust and the guarantee agreement constituted an "arrangement" and, therefore, a settlement of which the Respondent was the settlor. The income arising under the settlement comprised the dividends paid to the trustees on their shares in E. I Ltd. The Respondent had an interest in that income to the extent that it was applied in discharging the trustees overdraft; such income was applicable for the benefit of the settlor since it "entitled him to withdraw an equivalent amount of his frozen capital."[1] Goff, J. relied on the judgement of Lord Greene, M. R. in Jenkins v. I.R.C.[2] in which the Master of the Rolls accepted the proposition that income used in paying off an interest-free loan made by a settlor was income applied for the benefit of the settlor.

It would appear from the dicta in Wachtel's case that if a settlor loans a sum to trustees at a commercial rate of interest, the repayment of that loan will not amount to the application of trust income for the benefit of the settlor. The loan arrangement in such case is a commerical transaction. However, presumably the benefit derived by the lender from the repayment of an interest-free loan would be considerably greater than the repayment of a loan at a commercial rate of interest which, while in the hands of the borrower is, in effect, producing income on behalf of the lender. According to Burgess:

1. (1971) 46 T.C. 543, at p. 556.
2. (1944) 26 T.C. 265.

> " ... in the Jenkins/Wachtel situation, where there was no interest or it was negligible, one could argue that during the continuance of the loan the asset was sterile and that, as repayment would permit the settlor to employ his money more profitably, such repayment was obviously for his benefit. This argument has much less force where the loan is put out at a commercial rate of interest."[1]

The problem common to both loans to a settlor and to the repayment of loans made by a settlor would appear to be associated with determining at what point the benefit derived by him is merely incidental to a commercial transaction. A workable solution is suggested by Burgess:

> "Perhaps the true position is that the existence of a commercial rate gives rise to a presumption that any benefit by way of repayment is only incidental, but as with all other presumptions, one that can be rebutted. This would be done by adducing evidence to show that looking at the transaction as a whole, the benefit in question was more than "incidental."[2]

In conclusion it can be stated that a truster is deemed to have an interest in the income or property of a trust if it is, will or may become payable to or applicable for the benefit of himself or his spouse under the terms of the trust or under some collateral arrangement having legal force. If the collateral arrangement is of a commercial nature, for instance a commercial loan agreement, on the basis of the dicta in the Vestey and Wachtel cases, any income payable thereunder to the truster is not payable to or applicable for his benefit within the meaning of s. 447(2).

In addition to the previously discussed judicial interpretations of s. 447(2) which effectively limit the scope of the deeming provision, where the proviso to s. 447(2) applies a truster is not deemed to have an interest in either the income or property of the trust.

1. [1971] B.T.R. 278, at p. 285.
2. Ibid., at p. 285.

The proviso to s. 447(2)

The proviso to s. 447(2) is essentially an undeeming provision and reads as follows:

> " ... the settlor shall not be deemed to have an interest in any income arising under or property comprised in a settlement -
>
> (a) if and so long as that income or property cannot become payable or applicable as aforesaid /̄ i.e. to or for the benefit of the settlor or his spouse_7 except in the event of -
>
> (i) the bankruptcy of some person who is or may become beneficially entitled to that income or property; or
> (ii) any assignment of or charge on that income or property being made or given by some such person; or
> (iii) in the case of a marriage settlement, the death of both the parties to the marriage and all or any of the children of the marriage; or
> (iv) the death under the age of twenty-five or some lower age of some person who would be beneficially entitled to that income or property on attaining that age; or
>
> (b) if and so long as some person is alive and under the age of twenty-five during whose life that income or property cannot become payable or applicable as aforesaid except in the event of that person becoming bankrupt or assigning or charging his interest in that income or property."

The difference between paragraphs (a) and (b) is of particular relevance in circumstances where either the income or property of an accumulation trust may revert to the truster on the death of a beneficiary. If the income or property is due to vest in the beneficiary on his attaining the age of 30, then so long as he is under the age of 25 years, paragraph (b) protects the truster from the operation of s. 447 but paragraph (a) does not.[1]

1. See Simon, E6.239.

iv) Income arising under a trust which is treated as the income of the truster for the purpose of computing his liability to higher rates of tax

S 457 of chapter IV is perhaps the most extensive of the provisions of Part XVI. It operates to treat the income arising under the trust as income of the truster for the purposes of computing his liability to tax at the higher rates. It does not operate in respect of tax at the basic rate. S. 457(1) provides:

> "Where, during the life of the settlor, income arising under a settlement made on or after 7th April, 1965 is, under the settlement and in the events that occur, payable to or applicable for the benefit of any person other than the settlor, then, unless, under the settlement and in the said events, the income either -
>
> (a) consists of annual payments made under a partnership agreement to or for the benefit of a former member, or the widow or dependants of a deceased former member, of the partnership, being payments made under a liability incurred for full consideration, or
> (b) is excluded by subsection (1A) or (2) below, or
> (c) is income arising under a settlement made by one party to a marriage by way of provision for the other after the dissolution of the marriage, or while they are separated under an order of a court or under a separation agreement or in such circumstances that the separation is likely to be permanent, being income payable to or applicable for the benefit of that other party, or
> (d) is income from property of which the settlor has divested himself absolutely by the settlement, or
> (e) is income which, by virtue of some provision of the Income Tax Acts not contained in this Chapter, is to be treated for all the purposes of those Acts as the income of the settlor,
>
> the income shall, for the purposes of excess liability, be treated as the income of the settlor and not as the income of any other person.
>
> In this subsection "excess liability" means the excess liability to income tax over what it would be if all income tax were charged at the basic rate to the exclusion of any higher or additional rate."

Subsection (1A) provides that subsection (1) does not operate in respect of covenanted payments to charity except to the extent that the payments exceed £3,000 in any year.[1]

Subsection (2) of s. 457 exempts from the operation of subsection (1) annual payments made under a liability incurred for full consideration in connection with the acquisition of a business. If such payments are to be exempt, they must be made to the vendor of the business, or, if he is dead, to his widow or dependants.[2]

Thus, assuming the truster has avoided the operation of the various alternative provisions of Part XVI, s. 457 will usually prevent him absolving his liability to tax at the higher rates on income which he has attempted to alienate.

An important exception to s. 457 is contained in s. 457(1)(d). Under s. 457(1)(d) income arising from the capital of a trust will not be treated as the income of the truster provided he has divested himself absolutely of the trust property. However, according to s. 457(6), the truster shall not be deemed to have divested himself absolutely where the trust property or income therefrom is, will or may become payable to or applicable for the benefit of the truster or his spouse in any circumstances whatsoever. Thus, a truster is not deemed to have divested himself absolutely of trust property in circumstances where he would be deemed to have an interest in the income arising under a settlement of capital by virtue of s. 447(2), or would be so deemed but for the proviso to s. 447(2). Many of the cases which are discussed above in connection with the interpretation of s. 447(2) are equally applicable to s. 457(6).

1. "Covenanted payment to charity" is described above, at p.102.
2. Special rules apply where the vendor was a partnership: see s. 457(2) (b), (3), (4A) and (5).

As in s. 447(2), the operation of the doctrine of resulting trusts may have unfortunate consequences for the truster who has not completely disposed of the trust property. In Vandervell v. I.R.C.[1] the Appellant transferred part of his shareholding in a limited company to a charity. The charity granted to V.T. Ltd. (a trust company) an option to purchase the shares for £5,000; on the facts of the case it was thought that the Appellant, acting by his agent, had procured the granting of the option.[2] The Appellant failed to specify for what purpose V. T. Ltd. was to hold the option, though it was admitted by a director of that company that the shares acquired on the exercise of the option would be held on trust, but he could not say for whom.

The Crown successfully argued that the trust company held the option on resulting trust for the Appellant. He had not, therefore, absolutely divested himself of the shares in question. Accordingly, the income arising from those shares was treated under s. 457(1) as the income of the Appellant for the purpose of computing his excess liability to tax. A truster is not deemed not to have divested himself of the trust property under s. 457(6) if either that property or income therefrom can revert to him in the event of -

> "(a) the bankruptcy of some person who is or may become beneficially entitled to any such property or income; or
> (b) an assignment of or charge on any such property or income being made or given by some such person; or
> (c) in the case of a marriage settlement, the death of both parties to the marriage and of all or any of the children of the marriage; or
> (d) the death under the age of twenty-five or some lower age of some person who would be beneficially entitled to that property or income on attaining that age.

1. (1966) 43 T.C. 519.
2. Per Lord Upjohn, Ibid., at p. 558.

It will be noticed that the proviso to s. 457(6) and paragraph (a) of the proviso to s. 447(2) are similar. However, s. 457(6) contains no provision as in paragraph (b) of the proviso to s. 447(2).[1]

S 457 and the additional rate complication

Income arising under a settlement is not earned income within the meaning of s. 530(1), I.C.T.A. Thus, where s. 457(1) operates to treat the income arising under a trust as the income of the truster, he 'receives' that income in the form of investment income[2] and may be liable to tax at the additional rate thereon by virtue of s. 32(1), Finance Act 1971. Hence, where s. 457(1) applies, original payments made to trustees out of earned income will be redirected to the truster in the form of investment income which is susceptible to a charge to tax at the additional rate. This may have the effect of increasing the amount of tax chargeable on the income over what would have been charged had the trust never been constituted. This rather anomalous position is a consequence of the decision of Walton, J. in Ang v. Parrish.[3]

The facts in Ang v. Parrish were as follows. By deeds, the taxpayer and his wife covenanted to pay to the taxpayer's parents certain annual sums. The payments were made largely out of earned income and were paid after deduction of tax at the basic rate under s. 52, I.C.T.A. It was successfully argued by the Crown that the income paid under the covenants was "income arising under a settlement" which was to be treated as the income of the settlor under s. 457(1). The income arising under the settlement was investment income chargeable to tax at the additional rate by virtue of s. 32(1), Finance Act 1971.[4]

1. Supra. at p. 118.
2. In general, any income which is not earned income is investment income s. 32(3), Finance Act 1971.
3. [1980] S.T.C. 341.
4. For a review of the decision and of the unsuccessful attempts of the taxpayer to resist the assessment to tax at the additional rate, see Jones: Journal of the Law Society of Scotland, January, 1981.

S. 457(1) was does not, therefore, operate to prevent the truster from deducting from his total income payments made to trustees. The payments are deductible, but are added back for the purposes of computing the truster's liability to tax at the higher and additional rates. In effect, the truster is treated as the beneficiary of the trust who, according to the principle in Fry v. Shiels' Trustees,[1] is never entitled to claim that the income which he receives from the trust is in any sense earned. In this respect, the actual source of the trust's income is immaterial.

D) INCOME FLOWING FROM THE TRUSTEES TO THE BENEFICIARY - FLOW 3)

> "In regard to this proposal of the Government, it is known to everyone that for years wealthy men with young families have been setting aside so much for each child, thereby getting the full allowance for the child, and reducing the rate of tax. That has been done deliberately for the purpose of avoiding Income Tax and Super Tax. These people have not only been depriving the Exchequer of money, but they have been causing other people to pay more Income Tax and Super Tax as a result of their action ... If a certain number of people can, by means of these trusts, avoid paying their fair share of Income Tax and Super-Tax, it means that other people have to pay a higher rate."[2]

Where the beneficiary of a trust is an infant unmarried child of the truster, income flowing to that beneficiary from the trustees is treated as the income of the truster. It is in these circumstances only that it is necessary to look to the flow of income from the trustees to the beneficiary for the purposes of Part XVI. S. 437(1) provides:

1. (1914) 6 T.C. 583.
2. Official Report, 20th June, 1922; Vol. 155 c. 1211: (per Holmes).

"Where, by virtue or in consequence of any settlement to which this Chapter applies and during the life of the settlor, any income[1] is paid to or for the benefit of a child[2] of the settlor in any year of assessment, the income shall, if at the time of the payment the child was unmarried and below the age of eighteen be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person."[3]

The subsection does not apply where the total income paid to the child does not exceed £5 in any year of assessment.[4]

Income which is deemed to be paid to an infant unmarried child of the truster

According to s. 438(1), where, by virtue or in consequence of the trust, income is dealt with such that it will or may become payable to an infant unmarried child of the truster in the future (on the happening of a contingency or on the exercise of a discretion or otherwise), that income is deemed to be paid to the child beneficiary. Thus, where income is accumulated in the hands of the trustees it may be deemed to be paid to the child of the truster under s. 438(1), and so treated as the income of the truster under s. 437(1). If there are several discretionary objects of an accumulation trust, the accumulated income is deemed to be paid in equal shares to those objects who are infant unmarried children of the truster.[5]

1. "Income" except in the phrase "be treated for all the purpose of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person "includes any taxable income charged by deduction or otherwise, or would have been taxable if it had been received in the U.K. by a person resident or ordinarily resident in the U.K. - s. 444(2).
2. "Child" includes stepchild, adopted child and illegitimate child, - s. 444(1).
3. For the application of s. 437(1) see Copeman v. Coleman, (1939) 22 T.C. 594; Hood Barrs v. I.R.C., (1946) 27 T.C. 385; Thomas v. Marshall, (1953) 34 T.C. 178 I.R.C. v. Buchanan, (1957) 37 T.C. 365; Crossland v. Hawkins, (1961) 39 T.C. 493 and I.R.C. v. Leiner, (1964) 41 T.C. 589
4. S. 437(3).
5. S. 438(1)(b).

However, s. 438(1) does not apply to irrevocable settlements unless and only to the extent that the income accumulating in the hands of the trustees is derived from payments of income made by the truster which are allowable as deductions in computing his total income.[1]

Thus, the income arising from the capital of an irrevocable trust which is accumulated in the hands of the trustees is not deemed to be paid to the child beneficiary under s. 438(1). This income may be harmlessly accumulated and capitalized by the trustees although it will suffer tax at the additional rate as well as the basic rate by virtue of s. 16, Finance Act 1973.

Any subsequent payment of capital to an infant unmarried child of the settlor will be treated as a payment of income. The extent to which the payment may be treated as income is, however, limited. If the sum paid, together with other sums so paid (whether to that child or any other infant unmarried child) exceeds the aggregate of the trust income which has been paid to the child of the truster and the income accumulated by the trustees since the date that the trust was executed or became irrevocable (which ever is the later), then the excess is not to be treated as income.[2] The purpose is to tax as income, payments of capital which represent the trust income which has been accumulated and capitalized in the hands of the trustees. The original capital of the trust (the capital transferred on its creation) if paid to the beneficiary will not be treated as income under s. 438(2).

The concept of the "irrevocable settlement"

The deemed payment under s. 438(1) of income arising from the trust property which is accumulated in the hands of the trustees is avoided only if the trust is irrevocable. The term "irrevocable" has an accepted meaning at common law, though this meaning is extended in s. 439.

1. S. 438(2)(a).
2. S. 438(2)(b).

The common law notion of irrevocability was discussed in I.R.C. v. Warden[1]. In Warden's case, a trust was determinable at the instance of the trustees; there was no power of revocation in the truster. The power of the trustees was sufficient to render the trust revocable. The Lord President (Normand), Lords Moncrieff and Carmont were all of the opinion that the trust was revocable according to the common law of Scotland, and that, therefore, it was unnecessary to consider the effect of s. 439. The Lord President (Normand) stated:

> "It was said that a deed, according to the common law of Scotland, was irrevocable unless it was revocable by the act of the truster alone. In my opinion, a deed is revocable if it is terminable either by the truster or by persons appointed by the truster with a power to terminate."[2]

A settlement is not revocable at common law merely because the truster has some extrinsic power to recover the trust property. In Jenkins v. I.R.C. the trust fund comprised shares in a company over which the settlor had control. The settlor had the power to wind up the company, but this was held not to be a power to revoke the settlement. Lord Greene, M. R. was of the opinion that to consider otherwise would be 'placing too wide a construction on the word "irrevocable" ... taking it in its ordinary sense.' He continued:

> "The distinction between a revocable and an irrevocable settlement is the veriest A.B.C. in legal language; and nobody familiar with the language of lawyers, and in particular those concerned with settlements, could have the slightest doubt, I should have thought, when finding the word "irrevocable" used in relation to a settlement, what that word was intended to mean. It seems to me quite illegitimate to take a word which has a technical meaning in conveyancing and then to argue that it has some extended meaning.[3]

1. (1938) 22 T.C. 416.
2. Ibid., at p. 421.
3. (1944) 26 T.C. 265, at p. 281: see also I.R.C. v. Delamere, (1939) 22 T.C. 525.

The effect of s. 439 is to treat certain settlements which are irrevocable at common law as revocable for the purpose of chapter II of Part XVI: as Macnaghten, J. explained:

> " ... [s. 439(1)] appears to relate to cases where a settlement appears on the face of it to be irrevocable and it provides that nevertheless it is to be deemed revocable in the circumstances set out in sub-paragraphs (a), (b) and (c)."[1]

S. 439(1) provides:

> " ... a settlement shall not be deemed to be irrevocable if the terms thereof provide -
>
> (a) for the payment to the settlor or, during the life of the settlor, to the wife or husband of the settlor for his or her benefit, or for the application for the benefit of the settlor or, during the life of the settlor, or the wife or husband or the settlor, of any income or assets in any circumstances whatsoever during the life of any child of the settlor to or for the benefit of whom any income, or assets representing it, is or are or may be payable or applicable by virtue or in consequence of the settlement; or
> (b) for the determination of the settlement by the act or on the default of any person; or
> (c) for the payment of any penalty by the settlor in the event of his failing to comply with the provisions of the settlement:
> Provided that a settlement shall not be deemed to be revocable by reason only -
> (i) that it contains a provision under which any income or assets will or may become payable to or applicable for the benefit of the settlor, or the wife or husband of the settlor, on the bankruptcy of any such child as is mentioned in paragraph (a) of this subsection or in the event of an assignment of or charge in that income or those assets being executed by such child; or
> (ii) that it provides for the determination of the settlement as aforesaid in such a manner that the determination will not, during the lifetime of any such child as aforesaid, benefit the settlor or the wife of husband of the settlor; or
> (iii) in the case of a settlement to which section 33 of the Trustee Act 1925 applies, that it directs the income to be held for the benefit of such a child as aforesaid on protective trusts, unless the trust period is a period less than the life of the child or the settlement specifies some event on the happening of which the child would, if the income were payable during the trust period to him absolutely during that period, be deprived of the right to receive the income or part thereof."

1. I.R.C. v. Lord Glenconner, (1941) 24 T.C. 82, at p. 85.

Clearly, s. 439 adds considerably to the scope of settlements which may be described as revocable for the purposes of chapter II. For example, in Jamieson v. I.R.C.[1] trustees held £10,000 in trust. By clause 3 of the trust deed, the trust fund (representing the £10,000 and the income therefrom) was to be held in trust for, inter alia, the children of the settlor and their wives and issue absolutely or for such successive interests as the trustees in their discretion should appoint.

Applying the principle in I.R.C. v. Kenmare,[2] the Lords held that the terms of the settlement were such that the trustees could determine the trust by appointing the trust fund absolutely to any particular beneficiary. The settlement was, therefore, revocable by reason of s. 439(1)(b).[3]

However, if a settlement which is irrevocable at common law is to be treated as revocable by reason of it containing any provision mentioned in either paragraph (a), (b) or (c) of s. 439(1), then that provision must be found in the terms of the settlement. This is as a result of the decision of the Court of Appeal in Jenkins v. I.R.C.[4] If, for example, the settlement may be determined by the act or default of any person, s. 439(1)(b) applies only if, according to the terms of the settlement it may be so determined.

1. (1963) 41 T.C. 43.
2. (1937) 37 T.C. 383.
3. It was unsuccessfully argued that by appointing the trust fund absolutely, the trustees would not be determining the settlement, but would be merely fulfilling the purpose of the trust.
4. (1944) 26 T.C. 265.

Although the operation of s. 439(1) is restricted by the decision in Jenkins v. I.R.C., the same caution applies to any attempt to exploit the loop hole created by the case that was mentioned earlier in respect of s. 445(1) and the exploitation of the decision in Wolfson v. I.R.C.[1]

Interest paid by the trustees which is deemed to be paid to the infant unmarried child of the settlor

By virtue of s. 440(1), interest paid by trustees of a settlement to which chapter II applies may be deemed to be paid to the beneficiary of the trust where that beneficiary is an infant unmarried child of the truster; such interest is treated as the income of the truster under s. 437(1).

The amount of the interest which is deemed to be paid to the child is the fraction $\frac{B}{A}$ of the interest, where A is the income arising under the trust less expenses properly chargeable to income (but not the sums distributed to the beneficiaries of the trust), and B is such part of A that is paid to any infant unmarried child of the truster.

S. 440 does not apply where the interest is paid to the truster or his spouse (if living with the truster), nor does it apply to interest in respect of which tax relief is available.[2]

PAYMENTS OF CAPITAL SUMS BY THE TRUSTEES TO THE TRUSTER

> "The need for this clause, ... is that certain people have set up machinery under which the income goes in at one slot and the same amount of money comes out below, but when it comes out below, they say it is a capital payment,

1. (1949) 31 T.C. 141, supra, at p. 88.
2. S. 440(2).

> whereas they deduct from their total returns what they have put into the slot above. Therefore, that machinery ... has to be dealt with."[1]

S. 451 has the effect of treating certain payments of capital made by the trustees to the truster as payments of income. The object of the section is evident from the statement above. It is to prevent an individual from supplying a trust with income on which he would otherwise have been assessable to tax; the income being capitalized in the hands of the trustees to be repaid to him in the form of a non-taxable capital sum. S. 451 certainly achieves this objective, though as a provision of the Income Tax Acts it will be demonstrated that it is little short of disgraceful.[2]

The problems associated with the section are twofold: it must be determined (1) what a capital sum is and when it is paid directly or indirectly to the truster, and (2) to what extent the sum is to be treated as income.

S. 451(1) provides:

> "Any capital sum paid directly or indirectly in any relevant year[3] of assessment by the trustees of a settlement to which this section[4] applies to the settlor shall—
>
> (a) to the extent to which the amount of that sum falls within the amount of income available up to the end of that year, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year;
> (b) to the extent to which the amount of that sum exceeds the amount of income available up to the end of that year but falls within the amount of income available up to the end of the next following year, be treated for the purposes aforesaid as the income of the settlor for the next following year,
>
> and so on."

1. Official Report, 27th June, 1938; Vol. 337 c. 1643: (per Attorney-Gen).
2. See generally the Inland Revenue consultative paper: "The Taxation of Certain Sums paid to Settlors: Section 451, Taxes Act 1970".
3. "Relevant year" means any year of assessment after the year 1937-38: - s. 451(8).
4. The section applies to any settlement wherever made: - s. 451(8).

1. a) The capital sum

"Capital sum" is defined in s. 451(8) as follows:

> "(i) any sum paid by way of loan or repayment of a loan; and
> (ii) any other sum paid otherwise than as income, being a sum which is not paid for full consideration in money or money's worth, but does not include any sum which could not have become payable to the settlor except in one of the events specified in the proviso to section 447(2) above, and ...
>
> references to sums paid to the settlor include references to sums paid to the wife or husband of the settlor."

It is regrettable that, in consequence of the drafting of subsection (8) in such wide terms, s. 451 catches innocent transactions which are not entered into for the purposes of tax avoidance. The severity of a strict application of the section was revealed in I.R.C. v. De Vigier.[1]

In January, 1952, the Appellant in De Vigier's case executed a settlement of which the Appellant's wife was a trustee. He transferred to the trustees shares that he held in A. Ltd. The settlement was in favour of his infant unmarried children; the income arising under the settlement was to be accumulated until the children attained the age of twenty-five, though there were limited powers of advancement.

In tax year 1957-58 the Appellant's wife paid into the account of the trustees an amount of £7,000. This was done in order that the trustees had funds available to them to take advantage of a rights issue by A. Ltd. In tax year 1958-59 the sum of £7,000 was paid back to the Appellant's wife.

1. (1964) 42 T.C. 24.

The Crown contended that the sum totalling £7,000 was paid to the Appellant's wife as the repayment of a loan and was, therefore, the payment of a capital sum; accordingly the Appellant was assessed to tax under s. 451. Against this the Appellant urged that the payment from the trust account to his wife was nothing more than a mere indemnity payment to cover the expense of £7,000 advanced on behalf of the trust by his wife as a trustee.

The House of Lords with the utmost regret could not view the payment otherwise than as the repayment of a loan. There was, therefore, the payment of a capital sum to the wife of the Appellant, hence the Appellant was assessed to tax under s. 451. Lord Pearce explained:

> "The words "repayment of a loan" must, in my opinion, be given their ordinary meaning. It does not follow that an indemnity to which a trustee is entitled from the trust is the repayment of a loan by him. In such cases it is a question of fact whether the circumstances under which the trustee is entitled to his indemnity constitute a loan. There may be borderline cases where a Court is entitled to hold that a temporary payment by a trustee into a trust account does not come within the word "loan". In the case before us, however, I do not think it is possible so to hold. The difficulty of excluding Mrs. De Vigier's transaction from the category of a loan is shown by the periphrases necessary in argument to describe it in neutral terms, such as "putting up the money", "making an advance" and "putting the trust account in funds". The simplest and most natural way of describing it is that she "lent the money" or "made a temporary loan" to the trust. Either of these descriptions is fatal to the Appellant's argument."[1]

A loan made to the truster by the trustees is the payment of a capital sum whether or not it is secured or is at a commercial rate of interest; it is of no consequence that the trustees regard the transaction as an investment. In <u>McCrone</u> v. <u>I.R.C.</u>[2], the truster (the Appellant in the case) executed a settlement of capital in December, 1946. The trustees were to accumulate the income; the trust property and accumulations were to be paid over in equal shares to the truster's daughters on their attaining the age of twenty-five.

1. Ibid., at p. 37-38.
2. (1967) 44 T.C. 142.

In July, 1958, the truster suggested that the trustees should make a loan to him of £45,000. The trustees responded to the truster's request by transferring to him £45,000 worth of securities; the loan was secured over the truster's farm, and he was obliged to pay interest at the rate of 6%.

The Revenue argued that the loan was a payment of a capital sum to a settlor by the trustees of a settlement which must be treated as the income of the settlor under s. 451.

Resisting the assessment the truster argued that the securities were transferred for full consideration in money or money's worth, and that a "loan" for the purpose of s. 451(8) in effect means an unsecured loan; it was further argued that the section applies where the trustees deliberately make a loan to the settlor but not where their sole motive is to invest the trust fund.

The First Division of the Court of Session dismissed the truster's arguments. The fact that the loan was secured was of no assistance to the Appellant's case. Lord Migdale remarked:

> "Counsel for the Appellant contended that there was a difference between a loan which was secured and one which was not. I cannot see why a loan which is secured should be in a different position to one which is not secured. All it does is to better the prospects of the lender getting his money back."[1]

Moreover, the fact that the trustees regarded the transaction as an investment did not alter its nature as a loan arrangement:

> "The ... submission for the Appellant, that because the trustees regarded the transaction as an investment it could not be a loan, is even more unstateable. The trustees thought that an application of trust funds to obtain a return of 6 per cent per annum on the money, repayment being secured by a disposition of a farm, was a wise policy. That circumstance in no way affects the conclusion that, in order to obtain a return of 6 per cent., they lent a portion of the trust funds to the Appellant."[2]

1. Ibid., at p. 151.
2. Ibid., at p. 149: per Lord Guthrie.

It should be noted that the payment to the truster in McCrone's case consisted of the transfer of stocks, though the truster was obliged to repay £45,000. The Court of Session did not regard it of any significance that the first stage of the transaction was completed by the transfer of securities. The Lord President (Clyde) stated:

> "It is true that the form in which the transaction was carried through involved a transfer of stocks, the amount of which depended upon their realisable value at the time in the market. But I am unable to hold that the way in which the loan was carried out can in any way detract from its nature as a loan of £45,000."[1]

However, this is not to say that a payment of trust property will necessarily amount to a payment of a capital sum for the purposes of s. 451. It was pertinent to the decision in McCrone's case that the truster was obliged to repay to the trustees the sum of £45,000. It would appear, particularly from the judgement of Lord Guthrie,[2] that had the securities been transferred to the truster subject to an agreement to retransfer those same securities, then there would have been no payment of a capital sum, and hence no assessment under s. 451.

Particular difficulty has arisen in respect of the truster who operates a current account with a body corporate connected with the settlement.

A body corporate is connected with a settlement if it is a close company the participators of which include the trustees or a beneficiary under the settlement.[3] For the purpose of s. 451, the payment to the settlor of a capital sum by a body corporate connected with the settlement is treated as if it had been paid by the trustees.[4] Thus, if the truster overdraws his account with

1. Ibid., at p. 147.
2. Ibid., at p. 149.
3. S. 454(4).
4. S. 451(4)

the company and the overdraft represents a "loan", he will be deemed to have been paid a capital sum by the trustees of the settlement equal to the amount by which he is overdrawn.

The problem arose in Potts' Executors v. I.R.C.[1] where the settlor sold to the trustees of the settlement all but one of his shares in a company of which he was a director. The company was a body corporate connected with the settlement.

The settlor had a current account with the company. The account was credited with the settlor's fees and expenses as director of the company. It was debited in respect of sums paid by the company on behalf of the settlor at his request. During the tax years 1939-40 and 1940-41 the account showed a debit balance; the settlor had directed that substantial sums should be paid to the Inland Revenue to discharge his liability to tax. On 23rd December, 1940, the settlor paid into the account an amount to clear the debit.

There was no intention on the part of the settlor to avoid the payment of tax; the arrangement with the company was purely a matter of convenience. Neverthless, the settlor was assessed to tax under s. 451, the Crown alleging that the amounts by which the account showed a debit balance represented sums paid by way of loan to the settlor. The Crown argued that the loan was a payment of a capital sum; as the company was a body corporate connected with the settlement, then the capital sums paid were to be treated as having been paid by the trustees of the settlement under s. 451(4). Hence, the debit balance was to be treated as the income of the settlor under s. 451.

After some considerable discussion in the House of Lords as to the nature of the arrangement between the company and the settlor, the Crown's contention was dismissed. Had there been a banking arrangement, then according to the dictum of Lord Blackburn in Cunliffe Brooks & Co. v. Blackburn Benefit Society, there could have been little doubt that the overdraft represented a loan. According to Lord Blackburn in the Cunliffe case:

1. (1950) 32 T.C. 211.

"/ Bankers_7 ... are under no obligation to honour cheques which exceed the amount of the balance, or in other words, to allow the customer to overdraw. Bankers generally do accommodate their customers by allowing such overdrafts to some extent; when they do so the legal effect is that they lend the surplus to the customer ..."[1]

However, the majority in the House of Lords in Potts' case (Lord Morton dissenting) concluded that there was no banking arrangement. Lord Simmons considered that it would be 'an abuse of language or at least the merest colloquialism to speak of the transaction between the company and the settlor as a banking transaction.' He continued:

" ... according to the ordinary fair meaning of the words the company did not pay any sums to the settlor by way of loan. It would in fact be as inapt to say that the company paid him sums by way of loan when he was in debit on the account as to say that he paid the company sums by way of loan when he was in credit."[2]

Whether or not it is strictly necessary to consider the distinction between a loan and an overdraft is open to doubt. The vital question is to whom a capital sum is paid.

1. b) Payment of a capital sum directly or indirectly to the truster

Although the majority in the House of Lords considered that the overdraft in Potts' case did not represent a loan for the purposes of s. 451(8), it was further considered that the actual sums paid by the company were not paid directly or indirectly to the settlor. They were paid pursuant to the directions of the settlor to third parties in discharge of the settlor's liability thereto.

Of the words "capital sum paid ... indirectly ... to the settlor", Lord Normand opined:

1. (1884) 9 A. C. 857, at p. 864.
2. (1950) 32 T.C. 211, at p. 228.

> "In my view they are apt to cover payments made as loans to third parties through whom the payment reaches the settlor himself, but they are not apt to cover payments made to third parties who are not accountable to the settlor and are entitled to retain the sums as their own moneys. This is a taxing Act and its terms are not to be enlarged by reasoning that the same final result is achieved as by a loan made to the settlor followed by a payment made by him to the third party."[1]

In Potts' case, none of the sums paid by the company were paid to persons who were accountable to the settlor. The sums were not, therefore, paid indirectly to the settlor and hence no assessment could be made on him under s. 451(1).

The decision in Potts' Executors v. I.R.C. was considered by the House of Lords in the similar case of I.R.C. v. Bates.[2] The Respondent in I.R.C. v. Bates had settled shares of a company of which he was a director. He had a current account with the company which was often overdrawn; however, the Appellant paid in enough to meet the balance at the end of each financial year. In order to do so, the Appellant would overdraw sums from his bank, and at the beginning of the next financial year the company would pay out sufficient to cover the Appellant's bank overdraft. On three occasions the company paid the sums direct to the bank, but twice the sums were paid to the Appellant himself.

The company was a body corporate connected with the settlement. The Crown urged that the sums paid out by the company to cover the Appellant's overdraft were paid by way of loan; they were, therefore, to be treated as capital sums paid to the settlor by the trustees which should be taxed accordingly under s. 451(1).

The House of Lords decided that the only sums paid by the company which were assessable under s. 451(1) were those paid to the Appellant himself:

1. (1950) 32 T.C. 211, at p. 229.
2. (1966) 44 T.C. 225.

"In the present case it appears that in five different years payments were made by the company for the purpose of discharging the Appellant's debt to his bank. In three cases these payments were made direct to the bank and Potts' case shows that they were not caught by [s. 451]. But it so happened that in the other two years the payments were made by cheques drawn in favour of the Appellant and not in favour of the bank. It is this fortuitous circumstance alone that has brought the Appellant within the scope of [s. 451] and imposes on him liability for several thousands of pounds."[1]

The Appellant argued that the sums that he actually received were not paid by way of loan but were payments passing in the course of a running account. This argument was received with little sympathy: Lord Guest stated:

" ... it was suggested that these sums were not loans, but were payments passing in the course of a running account between the company and the Appellant. Even if they were, the sums were, in my opinion, none the less loans. I pose the rhetorical question - "if those sums were not loans, what were they?"[2]

Both the Potts and Bates cases demonstrate the s. 451(1) is concerned with capital sums paid to a truster or to a person accountable to him. Sums paid by trustees to third parties in discharge of the truster's liabilities are not sums paid by way of loan to the truster himself despite the fact that he is obliged to make good the trustees' deficit. There can be little doubt that in such case the trustees would be entitled to maintain an action in debt against the truster. However the creation of an action in debt against the truster is not the equivalent of granting a loan to him of the amount of the outstanding debt.

1. Ibid., at p. 262-263: per Lord Reid.
2. Ibid., at P. 266.

There is clearly a real distinction between a debt and a loan, though it is unfortunate that it should be of such fundamental importance to the operation of s. 451. The distinction drawn in Bates' case between the sums paid to the bank, which were not taxable, and the sums paid to the bank through the hands of the Appellant, which were taxable, may have been real, but it provided for an irrational application of a taxing provision.

It should be noted that if, pursuant to some arrangement with the truster, the trustees discharge his liabilities by payments of capital sums to his creditors, then, although those sums would not be paid to the truster for the purpose of s. 451, they would be applied for his benefit for the purpose of s. 447(2): in which case, the undistributed income of the trust would be treated as the income of the truster. Goff J. in I.R.C. v. Wachtel explained:

> "Paying the settlor's bills could well be a payment to a person not accountable, yet it would be directly or indirectly for the benefit of the settlor, though it would not be a payment indirectly to him."[1]

2. The extent to which a capital sum is treated as income

According to s. 451(1), a capital sum paid to the truster by the trustees is to be treated as a payment of income to the extent that it falls within the income available at the end of the year of assessment in which the sum is paid. If the sum exceeds the income available, then the carry forward provision operates as provided by s. 451(1)(b).[2]

The means of calculating the amount of income available at the end of any year is provided by s. 451(2) as follows:

1. (1971) 46 T.C. 543, at p. 559.
2. Supra, at p. 130.

"For the purposes of subsection (1) of this section, the amount of income available up to the end of any year shall, in relation to any capital sum paid as aforesaid, be taken to be the aggregate amount of income arising under the settlement in that year and any previous relevant year which has not been distributed, less -

(a) the amount of any other capital sums paid to the settlor in any relevant year before that sum was paid, and
(b) so much of any income arising under the settlement in that year and any previous relevant year which has not been distributed as is shown to consist of income which has been treated as income of the settlor by virtue of section 445, 446, or 448 above, and
(c) any income arising under the settlement in that year and any previous relevant year which has been treated as the income of the settlor by virtue of section 447 above, and
(d) any sums paid by virtue or in consequence of the settlement, to the extent that they are not allowable, by virtue of section 450 above, as deductions in computing the settlor's total income for that year, and
(e) an amount equal to the sum of tax at the basic rate and tax at the additional rate on -

(i) the aggregate amount of income arising under the settlement in that year and any previous relevant year which has not been distributed, less
(ii) the aggregate amount of the income and sums referred to in paragraphs (b), (c) and (d) of this subsection."

The wording in s. 451(2) is unfortunate and has been extensively criticised both in the courts and by academic writers.

Silberrad[1] reviewed what he described as the "absurd results"[2] of a strict literal interpretation of the subsection. He noted that 'all accumulations of income made on or after April 6th, 1938, and prior to a year in which a capital sum is paid to the settlor are "income available", in addition to the undistributed income of the year in which the payment is made.' The difficulty is that the income which is available at the end of the year in which the payment of

1. "The Misdrafting of Section 451 of the Income and Corporation Taxes Act 1970": [1970] B.T.R. 380.
2. Ibid., at p. 384-387.
3. Ibid., at p. 385.

capital is made does not cease to be "income available" at the end of that year merely because there has been a capital sum paid to the settlor. Likewise, in subsequent years the fact that sums are treated as the income of the settlor by reason of the carry forward provision of s. 451(1)(b) has no bearing on the amount of "income available" at the end of those years. There is no difficulty where the capital sum paid is less than the amount of the income available at the end of the year in which the payment is made; the difficulty arises where the payment exceeds that amount. Lord Reid illustrated the problem:

> "Suppose loans of £20,000 are made by the connected company in year 1, which is the first in which the trustees receive income. That, after making the calculations in subs. (2) (b) and (e), is £3,000. That £3,000 is added to the settlor's income for year 1. It is the calculation directed for year 2 which gives rise to the absurdity. Suppose the trust income in year 2 to be £2,000 then the "income available" up to the end of year 2 is the sum of the incomes of the years 1 and 2, i.e. £5,000 because there was a direction to accumulate. And if in year 3 there is trust income of £3,000 the 'income available' at the end of that year is the sum of the incomes for year 1, 2, and 3, i,e. £8,000. In year 2 £5,000 will be treated as the income of the settlor and in year 3 £8,000 will be treated as his income, so, although the trust income for three years was only £8,000 in all, the settlor's income for those years will be regarded as increased by £3,000 plus £5,000 plus £8,000, i.e. £16,000, or double the whole trust income.[1]

In practice, the Inland Revenue do not strictly enforce s. 451(2).[2] It would appear that they set against the actual amount of income available at the end of any relevant year the amount of the capital sum which has been treated as the income of the settlor in any previous relevant years.[3]

The formula provided by s. 451(2) for the calculation of the 'income available' at the end of any year leads to further problems in respect of both s. 457 and s. 438(2)(b).

1. I.R.C. v. Bates, (1966) 44 T.C. 225, at p. 261.
2. The concession was made in Bates' case.
3. An example of the computation in accordance with the Revenue concession is provided in Simon, E6.245.

From the undistributed income of the settlement there is deducted, inter alia, any income which has been treated as the income of the settlor under sections 445, 446, 447 and 448, together with any income which, by virtue of s. 450, the settlor has not been allowed to deduct in computing his total income. The remainder represents income available at the end of the year for the purpose of s. 451. However, s. 451(2) does not provide for the deduction of any income which has been treated as the income of the settlor by virtue of s. 457 or s. 438(2)(b).

S. 457 does not apply to income arising under a settlement which is treated as the income of the settlor under any other provision of the Income Tax Acts.[1] The section does not, therefore, normally apply to the undistributed income arising from the property of a settlement of which the settlor has not absolutely divested himself. This income will usually be treated as the income of the settlor by virtue of s. 447. However, s. 457 would apply to that income if, for instance, it was not treated as the income of the settlor under s. 447 by reason of the operation of paragraph (b) of the proviso to s. 447(2).[2]

It is not therefore unrealistic to suggest that there are circumstances in which the 'income available' at the end of any year might include income which has been treated under s. 457 as the income of the settlor.

Thus, income arising under the settlement may be treated as the income of the settlor under s. 457; if the income is accumulated in the hands of the trustees, and out of the accumulations there is paid to the settlor a capital sum, that capital sum is treated as his income under s. 451. The settlor will be taxed on the capital he receives and this, in effect, amounts to a double taxation.

1. S. 457(1)(d).
2. It is also argued below that s. 457 can apply in circumstances in which s. 450 operates to prevent the settlor from deducting certain payments in computing his total income.

Where the capital sum exceeds the 'income available' in the year in which it is paid, then the amount of the settlement income (or part thereof) available in the next following year may be treated as the income of the settlor under s. 451(1)(b). This does not prevent the possibility that the actual income available in that next following year might be treated as that of the settlor under s. 457. This would not amount to a double taxation for in circumstances where s. 451(1)(b) applies it is not the actual income available in the next following year that is treated as the income of the settlor; that income is merely used as a measure to determine what portion of the capital sum is to be treated as the income of the settlor in that year. However, it is clearly grossly inequitable.

The disharmony between s. 438(2)(b) and s. 451 is, perhaps, more apparent.

Income of a settlement may be capitalized in the hands of the trustees. If it is paid to an infant unmarried child of the settlor in the form of a capital sum, by virtue of s. 438(2)(b), it may be treated as a payment of income. This in turn will be treated as the income of the settlor under s. 437(1).

The income available at the end of any year for the purposes of s. 451 includes the aggregate amount of income arising in that year and any previous relevant year which has not been distributed.[1] In effect, it includes any income accumulated by the trustees which has been paid to an infant unmarried child of the settlor as a capital sum which in consequence, has been treated as the income of the settlor.[2] Thus, income of the settlement which has already been treated as that of the settlor is used to determine what amount of a capital sum paid to him by the trustees is to be treated as his income under s. 451. This cannot in any sense be regarded as fair or reasonable and must be considered as an oversight of the legislature in drafting s. 451(2). Neither do the absurdities end here.

1. S. 451(2).
2. A payment of capital from income accumulated in past years does not affect the nature of the income while it accumulated as being undistributed for the purpose of chapter III - s. 455, discussed below at p. 146.

In accordance with s. 451(5), where any capital sum is treated as the income of the truster, it is treated as 'income of such an amount as, after deduction of both tax at the basic rate and tax at the additional rate for that year would be equal to that sum or part thereof.' Thus an actual capital payment of £55 represents income of £100 in the hands of the settlor. The settlor must therefore pay income tax on £100 which, if he were taxed at the basic rate would amount to £30; out of a payment of £55, a settlor who is assessed to tax at the basic rate receives a net amount of £25. In practice the Inland Revenue gross up a payment only for the purpose of charging it at the higher rates of the settlor.[1] There is, however, no rebate of tax for a settlor who would not have paid tax at the additional rate on the gross amount of the payment.

The full rigours of s. 451 are to a considerable extent mitigated by the extra-statutory concessions of the Inland Revenue as indicated above, and by the decisions in Potts' Executors v. I.R.C.[2] and I.R.C. v. Bates.[3]

A possible means of defeating the operation of s. 451 is to ensure that the income of the trust is distributed, leaving no "income available" at the end of any relevant year. A clause in the trust deed preventing the payment of capital sums by the trustees to the truster might operate to deter the trustees from making such payments, though s. 451 does not discriminate in favour of payments made in breach of trust.

The section obviously represents a trap for the unwary, and, if applied according to its literal interpretation, would operate with improper severity. However, it should be borne in mind that the absurdity attributed to the section relates only to its severity and not to its workability. The 1981 Finance Bill proposes certain amendments to s. 451; because these proposals are liable to change they are discussed in very general terms by way of appendix.[4]

1. See I.R.C. v. Bates, (1966) 44 T.C. 225.
2. (1950) 32 T.C. 211.
3. (1966) 44 T.C. 225.
4. Appendix 4.

PAYMENTS OF INCOME BY THE TRUSTER WHICH ARE NOT ALLOWED AS DEDUCTIONS FOR THE PURPOSE OF COMPUTING HIS TOTAL INCOME

S. 450 operates to prevent a truster from deducting from his total income annual payments made to the trustees to the extent that the payments are accumulated in the hands of the trustees and are not treated as the income of the truster by virtue of either s. 445, s. 446, s. 447 and s. 448. The section reads as follows:

> "Where, by virtue or in consequence of any settlement to which this section applies, the settlor[1] pays directly or indirectly in any year of assessment to the trustees[2] of the settlement any sums which would, but for this subsection, be allowable as deductions in computing his total income for that year, those sums shall not be so allowable to the extent to which the aggregate amount thereof falls within the amount of income arising under the settlement in that year which has not been distributed, less -
>
> (a) so much of any income arising under the settlement in that year which has not been distributed as is shown to consist of income which has been treated as the income of the settlor by virtue of section 445, 446 or 448 above, and
> (b) the amount of income so arising in that year which is treated as the income of the settlor by virtue of section 447 above.

The section does not prevent the truster from deducting basic rate tax under s. 52 or 53 on the annual payments made to the trustees; it merely disallows the deduction of such sums in computing his liability to tax at higher rates.[3]

An example of the application of s. 450 is provided by the case of I.R.C. v. Pay.[4] In this case the settlor settled £60,000 upon accumulation trust the ultimate beneficiary of which was her grandson. The trustees had wide powers of investment and in effect granted a mortgage to the settlor repayable with interest at 6%. The constitution of the trust and the granting of the mortgage occurred simultaneously: no money actually changed hands.

1. References to sums paid by the settlor include references to sums paid by the settlor's spouse: s. 450(5)
2. Sums paid to a body corporate connected with the settlement are treated as having been paid to the trustees: s. 450(2).
3. Tiley, at 19:76.
4. (1955) 36 T.C. 109.

The deed of settlement and the granting of the mortgage were held to constitute an arrangement and therefore a settlement for the purpose of chapter III of Part XVI.

The settlor, as mortgagor, attempted to deduct from her total income an amount equal to the annual payments of mortgage interest. The deduction was not allowed. It was held by Dankwerts, J. that the payments of interest were payable by virtue or in consequence of a settlement to which s. 450 applied: as most of the income of the settlement was undistributed, the payments of mortgage interest could not be deducted in computing the settlor's total income for tax purposes.

The meaning of income arising under a settlement which has not been distributed for the purposes of sections 447, 450 and 451

S. 455 provides that income arising under a settlement in any year of assessment shall be deemed not to have been distributed to the extent that it exceeds a certain amount. That amount is the aggregate of (a) the sums paid, other than payments of interest, which fall to be treated as the income of the persons to whom they are paid (except by virtue of s. 451), or would have been so treated had those persons received the sums in the United Kingdom and were themselves domiciled and resident or ordinarily resident in the United Kingdom; (b) the expenses of the trustees properly chargeable to income, other than those described in (a); and (c) in the case of a charity, any income arising to the trustees which is not dealt with as described in (a) or (b) above, but which would be granted an exemption from tax under s. 360, I.C.T.A.

Payments of interest by the trustees are expenses properly chargeable to income[1] unless the interest is paid to the settlor or his spouse, or is interest in respect of which tax relief is allowable.[2] However, a payment of interest is not an expense properly chargeable to income where there are no sums paid as

1. S.456(1).
2. S. 456(4).

described in (a) above to any persons other than the settlor or his spouse.[1] If such sums are paid to others as well as to the settlor or his spouse then a fraction of the interest paid by the trustees is an expense properly chargeable to income. That fraction is $\frac{A - B}{A}$ of the interest, where A is the whole income arising under the settlement less the expenses of the trustees other than payments of interest, and B is the amount of sums paid as described in (a) above to persons other than the settlor or his spouse.[2]

Example

Income arising under the settlement	£500
Sums paid to settlor	£100
Sums paid to persons other than settlor or his spouse	£150
Payments of interest in respect of which no tax allowance is available and which is not paid to the settlor or his spouse	£100
Expenses of trustees properly chargeable to tax	£50

Amount of interest which is properly chargeable to income:

$$\frac{(500 - 50) - 150}{(500 - 50)} \times 100 = £66.66$$

Undistributed income:

$$500 - (100 + 150 + 50 + 66.66) = \underline{£133.34}.$$

Part XVI as an indirect means of taxing the trust

Although most of the provisions of Part XVI discussed above operate to treat the income of a trust as income of the truster, many in fact represent the machinery by which the trust itself is indirectly taxed at the personal rate of tax of the truster. This is achieved by providing the truster who pays the tax with a right of action against the person who actually receives the income. S. 441 provides:

1. S. 456(2).
2. S. 456(3).

"(1) Where, by virtue of this Chapter,[1] any income tax becomes chargeable on and is paid by the person by whom a settlement was made or entered into, that person shall be entitled -

(a) to recover from any trustee or other person to whom the income is payable by virtue or in consequence of the settlement the amount of tax so paid; and
(b) for that purpose to require an inspector to furnish to him a certificate specifying the amount of income in respect of which he has so paid tax and the amount of the tax so paid,

and any certificate so furnished shall be conclusive evidence of the facts appearing thereby."

A similar provision applies to income which is treated as that of the truster by virtue of sections 445, 446, 447 and 448[2] and by virtue of s. 434[3].

Thus, although a truster bears the liability for tax on the income which is treated as his by virtue of those provisions of Part XVI, the actual financial burden rests on the trust itself. The trust, therefore, represents no loss of revenue to the Crown, and the payment of the tax is, in effect, ultimately borne by those who enjoy the income.

However, the truster cannot demand from the trustees reimbursement for tax paid on the amount of income which is treated as his pursuant to s. 451 or s. 457; nor can he recover his losses from the trustees which arise by reason of his inability to deduct payments from his total income in the circumstances described in s. 450.

THE INTEGRATION OF THE SECTIONS

It was noted above that Part XVI does not represent a scheme of taxation planned from the outset, or 'a code' in any shape or form.'[4] In general the provisions have been introduced at random to counteract specific forms of tax avoidance.

1. Chapter II - settlements in favour of infant unmarried children of the settlor.
2. See s. 449(3).
3. See s. 435(1)
4. Supra, at p. 51.

There is some discrimination in Part XVI between settlements of income and of capital. Settlements of capital of which the settlor has absolutely divested himself are treated with particular favour. The integration of the sections of Part XVI in relation to these two types of settlement will now be considered.

Settlements of income

In the final analysis it must be concluded that the income tax advantages associated with settlements of income are small.

In order that a truster can transfer to the trustees the burden of tax at the basic rate on income payments made by him under the terms of the trust he must ensure that -

(1) the payments are payable for a period which is capable of exceeding six years - s. 434;

(2) there is no power to revoke or determine the trust or any provision thereof on the exercise of which he will cease to be liable to make payments - s. 445 (subject to the six year proviso);

(3) the income cannot be paid to or applied for the benefit of himself or his spouse on the exercise of a power in any person - s. 448 (subject to the six year proviso);

(4) he has no interest in the income within the meaning of s. 447(2) thereby preventing an assessment on the undistributed income of the trust under s. 447;

(5) the beneficiaries of the trust are not his infant unmarried children - s. 437.

Should the truster comply with the five conditions outlined above, then any beneficiary who has unused personal allowances, in effect, may reclaim from the Revenue the tax deducted by the truster on making the payments.

Assuming that the truster is entitled to deduct from the payments of income an amount representing tax at the basic rate thereon, he cannot avoid liability to tax at his higher personal rates. To the extent that the income is accumulated, s. 450 prevents the deduction of the payments in computing the truster's total income. Apart from s. 450, unless either of the paragraphs of s. 457(1) apply, s. 457 operates to treat as the income of the truster any income arising under the trust for the purposes of computing his excess liability to tax. The relationship between s. 450 and s. 457 is somewhat confused. Tiley noted:

> "In view of the wide scope of s. 457 it may be wondered whether s. 450 is still needed. Both provisions are concerned only with excess liability and whereas s. 457 disallows the deduction completely no matter who is the payer, s. 450 is limited to income accumulated under the settlement ... The reason is to be found in the fact that s. 450 dates back to 1938 whereas s. 457 concerns only liabilities commenced since 1965 covenants entered into before that date being governed by the more generous s. 458."[1]

In the light of Ang v. Parrish[2] it is clear that s. 457 does not disallow a deduction of income payments made by the truster: it treats the income arising under the trust as the income of the truster which is an entirely different matter.

By virtue of s. 457(1)(e), the section does not operate in respect of income arising under a trust which is treated as the income of the truster under any provision of the Income Tax Acts other than those of chapter IV. However, s. 450 does not treat the income arising under the trust as the income of the truster; it has the effect of preventing the truster from deducting from his total income the payments that he makes under the terms of the trust, to the extent that the income is not distributed.

S. 450 operates on the same principle as s. 48 of the Finance Act 1977.[3] It will be recalled that according to s. 48, an annuity payment made under a liability incurred for money or money's worth is not allowed as a deduction from the total income of the person

1. 19:77, (written before the decision in Ang v. Parrish).
2. [1980] S.T.C. 341.
3. Supra, at p. 70.

by whom it is made. However, it cannot be doubted that the annuitant would be liable to tax on the amount that he received; the fact that the person by whom the annuity payment was made could not deduct the amount from his total income does not make that amount any less the income of the annuitant.

Likewise, payments made by the truster to the trustees which are caught by s. 450 are none the less income of the trustees. The payments therefore, represent income arising under a settlement for the purposes of s. 457. That income must be treated as the income of the truster for the purposes of calculating his excess liability to tax.

In accordance with the decision of Walton, J. in Ang. v. Parrish, and consistently with dicta in the House of Lords in Coathew Investments, Ltd. v. I.R.C.[1] the effect of s. 457 is to add to the total income of the truster the income arising under the trust. Thus, in cases where s. 450 applies, the payments of income are not deductible in computing the truster's total income, but those same payments represent income arising under the settlement which is added to the truster's income under s. 457 for the purpose of computing his excess liability to tax; this, in effect, amounts to a double taxation.

There is clearly some discord between the two sections, though no doubt by concession the Revenue would not seek to apply both sections in the same instance.

Income arising under a settlement which is treated as that of the settlor under s. 457 is taxed as investment income.[2] It must, therefore, be borne in mind that the constitution of a settlement of income may have the undesirable side-effect of rendering the settlor liable to the investment income surcharge.

1. (1966) 43 T.C. 301.
2. Ang v. Parrish, [1980] S.T.C. 341.

The payments of income by the truster to the trustees are treated by Part XVI as described above; however, the accumulations of income in the hands of the trustees become trust property or capital. Any income arising from the accumulations is treated as if it arose from a settlement of capital.

Settlements of capital

The income tax advantages associated with settlements of capital can be substantial. The operation of Part XVI can be avoided completely in respect of income arising from the property of a trust. However, as with settlements of income, before any advantage may be secured, the truster must first rid himself of liability to tax at the basic rate. He must ensure that -

(1) the income is payable to the trustees or any other person for a period which is capable of exceeding six years - s. 434;[1]

(2) there is no power to revoke or determine the trust or any provision thereof on the exercise of which he or his spouse might become beneficially entitled to the trust property - s. 446 (subject to the six year proviso);

(3) there is no power in any person to pay or apply the trust property to or for the benefit of himself or his spouse - s. 448 (subject to the six year proviso);

(4) he has no interest in the income or property of the trust within the meaning of s. 447(2) thereby preventing an assessment on the undistributed income of the trust under s. 447;

(5) if the beneficiary of the trust is his infant unmarried child, the trust is irrevocable and that neither the income arising or the accumulations of income are paid to the child during its infancy - s. 438.

The truster may avoid his liability to tax at higher rates by bringing the income arising under the trust within one of the exceptions to s. 457 provided by paragraphs (a) to (e) of subsection (1) thereof.

1. See I.R.C. v. Prince-Smith, (1943) 25 T.C. 84.

Particularly useful is s. 457(1)(d) by virtue of which the income arising from the property of the trust will not be treated as the income of the truster for the purpose of computing his excess liability to tax if he has divested himself absolutely of that property.

Thus, a settlement of capital of which the settlor has absolutely divested himself can represent a considerable saving of tax where the income is paid to a beneficiary (other than an infant unmarried child of the truster) who has a low personal rate of tax and where that income would have been charged at a high rate had it accrued to the truster.

Any income which is accumulated in the hands of the trustees will be assessed to tax at both the basic and additional rate by virtue of s. 16, Finance Act 1973. The process of accumulation is advantageous where both the truster and the beneficiary have personal rates of tax in excess of 45%. The accumulated income must, however, be paid to the beneficiary in the form of a non-taxable capital sum if the fiscal benefits of the accumulation are to be realized.

Although settlements of capital may represent an effective method of saving income tax, not unnaturally they attract charges to both capital gains and transfer tax. For the sake of completeness the structures of these two capital taxes are described in Part 3 below.

PART 3: THE CAPITAL TAXATION OF TRUSTS

CAPITAL GAINS TAX

Introduction

Unlike Part XVI, I.C.T.A., the Capital Gains Taxes Act 1979 provides a comprehensive structure or scheme of trust taxation the weaknesses of which are only now beginning to tell. The Finance Bill 1981 proposes certain amendments to the capital gains taxation of trusts; these proposals will be noted in the main text.

The scheme operates in respect of 'settled property' as defined by the Act, which throughout the life of the trust is the subject of disposals actual and deemed. Whiteman and Wheatcroft noted:

> "So far as settled property is concerned, chargeable gains or allowable losses may accrue (1) to the settlor on his disposal of assets on the creation of a settlement, (2) to the trustees on their disposal of trust assets during the administration of the trust, (3) to the trustees on a number of occasions when there is a deemed disposal of assets comprised in the settled property, and (4) to the beneficiaries on the disposal of their interests under the trust."[1]

Thus, in general the liability to capital gains tax tends to follow the legal ownership of the corpus of the trust fund.[2]

The disposal of the property by the settlor on the creation of the trust sets the base value of the settled property for future dealings by the trustees. Likewise, there is a deemed disposal by the trustees on the occasion that the property ceases to be settled property; the base value is thereby set for future dealings with the property by the person who becomes absolutely entitled thereto as against the trustee.

1. 9-01.
2. See Buckley, L. J. (dissenting) in Berry v. Warnett, [1980] S.T.C. 631, at p. 645.

The entire scheme hinges on the definition of 'settled property'. It is necessary, therefore, to begin by considering what is meant by settled property for the purposes of the Capital Gains Tax Act 1979.[1]

Settled property

The definition of settled property is provided by s. 51 and is essentially framed in the negative: any property which is held in trust other than property to which s. 46 applies is settled property for the purposes of the Act. S. 46 generally applies to property held by trustees who are required to act in accordance with the direction of the beneficiary: it reads as follows:

> "(1) In relation to assets held by a person as nominee for another person, or as trustee for another person absolutely entitled as against the trustee, or for any person who would be so entitled but for being an infant or other person under disability (or for two or more persons who are or would be jointly so entitled), this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the assets were the acts of, the person or persons for whom he is the nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly).
>
> "(2) It is hereby declared that references in this Act to any assets held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the assets for payment of duty, taxes, costs or other outgoings, to direct how that asset shall be dealt with."

Thus, in relation to any settlement, property held in trust to which a person is absolutely entitled as against the trustee is not 'settled property'. The concept of 'absolute entitlement as against the trustee' must not be confused with the concept of 'beneficial entitlement'. A person may be absolutely entitled as against the trustee although he himself acts in the capacity of a trustee.[2] Such a person is clearly not beneficially entitled to the property; however, the property may be settled property in relation to the settlement of which he is trustee.

1. Unless otherwise stated, references are to the Capital Gains Tax Act 1979.
2. See Hoare Trustees v. Gardner, (1977) 52 T.C. 53, below at p. 171.

The notion of two or more persons who are jointly absolutely entitled as against the trustee requires some explanation.

In Kidson v. Macdonald,[1] tenants in common of land were held to be jointly absolutely entitled to the land as against the trustees. Fox, J. appreciated that s. 46(1) applies in Scotland and Northern Ireland as well as in England and Wales, and so rejected an argument based on a technical aspect of English property law that the word "jointly" in s. 46(1) applies only in respect of property held in trust for two or more persons as joint tenants, but not to property held in trust for persons as tenants in common.[2] He explained:

> "In my judgement, the words used in [s. 46(1)] are not words which have a technical meaning; the word "jointly" is not a term of art in English real property law; and the word "jointly" should be given its ordinary meaning, namely, concurrently or in common."[3]

Fox, J. further noted that where successive interests are created in settled property, then although the beneficiaries are collectively entitled to direct the trustee as to his dealings with the property, they are not absolutely entitled as against the trustee for the purpose of s. 46(1):

> "If ... one has a trust for A for life with remainder to B absolutely, A and B together are able to direct the trustees how to deal with the settled property, but such a limitation is clearly settled property and is not excluded by [s 46(1)][4]

In Stephenson v. Barclays Bank Trust Co.,[5] property was held by the trustees of a will trust for such of the testator's grandchildren living at his death who should attain the age of twenty-one years.

1. (1973) 49 T.C. 503.
2. For the distinction between a joint tenancy and a tenancy in common, see Megarry and Wade, The Law of Real Property, 3th ed., chapter 7.
3. (1973) 49 T.C. 503, at p. 512-513: followed in Harthan v. Mason, [1980] S.T.C. 94.
4. Ibid., at p. 512.
5. (1974) 50 T.C. 374.

However, the interests of the grandchildren were subject to the prior rights of three annuitants entitled during their widowhood to annuity payments out of trust income.

It was urged on the basis of s. 46(2) that the grandchildren were absolutely entitled to the trust fund in that they had the exclusive right to direct how the trust property was to be dealt with, subject only to an outstanding charge, viz, the annuity payments which were, it was submitted, "outgoings" of the trustees. This argument was rejected by Walton, J.:

> "It does not appear to me to be in any way apt language for use in the case of another beneficial interest arising under the same instrument as the beneficial interest of the person said to be absolutely entitled as against the trustees. Such a person is not "absolutely entitled as against the trustee", what ever that phrase means, for the obvious reason that he does not, subject only to the excepted rights of the trustees, hold the entirety of the beneficial interest in the fund."[1]

It was also considered by Walton, J. that if beneficiaries are to be considered as jointly absolutely entitled as against the trustee then their interests must be qualitatively the same:

> "The definition says "jointly"; it does not say "together". I think this is because it is intended to comprise persons who are, as it were, in the same interest."[2]

The propositions in the Kidson and Barclays Bank Trust Co. cases were summarized by Sumption thus:

> "There are ... two requirements for the application of the provisions as to nominees and bare trustees where there is more than one beneficial owner. These are:
> (1) the interests of the beneficial owners must be concurrent and not successive. An example of the latter is the interest of a life tenant and remainderman; and
> (2) the interests of the co-owners should be the same.[3] The

1. Ibid., at p. 386.
2. Ibid., at p. 388.
3. As to the problems of ascertaining the qualitative similarity of the interests, see Whiteman and Wheatcroft, at 9:15.

section says "jointly" and not together and so tenants in common are capable of being together absolutely entitled."[1]

Both cases were considered in Booth v. Ellard,[2] a case which concerned a shareholders' voting agreement. The taxpayer and 11 other shareholders transferred their shares to trustees. The trustees were instructed to hold the shares in trust for the benefit of the 12 transferors. The trust was terminable at the instance of the majority. The income was to be distributed to the transferors in proportion to the number of shares which each individual transferred. There were special arrangements as to rights issues and voting rights.

The Crown argued that the transfer was a disposal of the shares on which a chargeable gain accrued to the taxpayer by virtue of s. 19(3).

Against this the taxpayer urged that he and the other transferors were jointly absolutely entitled to the shares as against the trustees. By virtue of s. 46(1), the property vested in the trustees was, for capital gains tax purposes, to be considered as being vested in the transferors: there was not, therefore, a disposal to which s. 19(3) could have applied.

The court held that, although the transferors' interests were in an undivided pool of shares, they were jointly absolutely entitled to the shares as against the trustees. The interests of the beneficial owners were concurrent and not successive and they were qualitatively the same; hence, the Crown's contention was dismissed.

It should be noted that, although s. 46(1) is expressed to apply to a person who would be absolutely entitled as against the trustee but for his being an infant or by reason of some other disability, the section applies only where the infancy or disability is the only bar preventing absolute entitlement as against the trustee. Thus, the section will not operate to treat as vested an interest which

1. "Absolutely entitled as against the trustee": [1980] B.T.R. 341, at p. 344.
2. [1980] S.T.C. 555. (Court of Appeal).

is contingent upon the beneficiary attaining his majority.[1]

In the majority of cases it will be obvious whether a trust comprises settled property or property to which s. 46 applies. Moreover, the draftsman of a settlement of capital created for the purpose of exploiting the income tax advantages of accumulation must ensure that no person is absolutely entitled to the trust property as against the trustee. By reason of the operation of the rule in Hamilton-Russell's Executors v. I.R.C.[2] the existence of such a person would nullify the beneficial fiscal effects of the accumulation.

Although the Act provides a definition of "settled property" for the purposes of trusts resident and domiciled in the United Kingdom, the terms "settlement" and "Settlor" are undefined. However, if the settlor is domiciled and resident or ordinarily resident in the United Kingdom but the trustees of the settlement are not resident or ordinarily resident in the United Kingdom, then the terms "settlement" and "settlor" have the meaning ascribed to them in s. 454(3), I.T.C.A.[3]

The trustees of a settlement

The trustees of a settlement are treated as a single and continuous body of persons, distinct from the persons who may from time to time be trustees.[4] The quasi-corporate nature of the body of trustees ensures that there are no capital gains tax consequences on the death or retirement of a trustee.

There is a presumption that the body of trustees is resident and ordinarily resident in the United Kingdom.[5] The presumption may be rebutted if it is shown that the general administration of the trust is carried on outwith the United Kingdom by trustees, the majority of whom are not resident or ordinarily resident in the United Kingdom. It is suggested in Whiteman and Wheatcroft that

1. Tomlinson v. Glyns Executor and Trustee Co., (1969) 45 T.C. 600
2. (1943) 25 T.C. 200.
3. S. 17(7).
4. S 52(1)
5. S. 52(1).

the general administration of the trust will be carried on outwith the United Kingdom 'if the trustee meetings are held, trustee resolutions discussed and passed, and trustee correspondence written outside the United Kingdom.'[1]

THE CHARGEABLE GAIN ACCRUING TO THE SETTLOR ON THE CREATION OF A SETTLEMENT

In accordance with s. 53, the creation of a settlement constitutes a disposal of the entire property thereby becoming settled property. This rule applies to revocable and irrevocable settlements alike, and it is matterless that the settlor retains some interest under the settlement or that he is a trustee thereof.

S. 53 relates to a 'gift in settlement'; however, it is proposed in the Finance Bill 1981 that from 10th March, 1981 the section shall apply to a 'transfer into settlement'.[2] The purpose of the amendment is to ensure that there is a complete disposal of assets on their becoming comprised in a settlement whether the settlement is made voluntarily or for full consideration in money or money's worth.

In Berry v. Warnett[3] the settlor constituted a settlement of shares of which he was the beneficial owner. The trustee, a Guernsey company, was directed to pay the income from the trust property to the settlor during his life with remainder to a Jersey company. The Jersey company paid full consideration for its interest in remainder.

The Court of Appeal held that as the transfer of shares to the trustee was for valuable consideration, there was no gift in settlement. The fact that no consideration moved from the disponee (the trustee) was of no consequence. The settlor was assessed to tax on the basis that he had made a part disposal of the property, viz, the legal interest in the shares.

1. 9:27.
2. Clause 82.
3. [1980] S.T.C. 631.

Thus it was possible to avoid the operation of s. 53 by the relatively simple expedient of substituting a sale in place of a gift in settlement.[1] Clause 82, Finance Bill is designed to effectively prevent this abuse.

In the case of a voluntary settlement, under s. 19(3)(a) the disposal by the settlor and acquisition by the trustee is deemed to be for a consideration equal to the market value of the property (the disposal being effected by bargain made otherwise than at arms length). However, the Finance Bill proposes the repeal of s. 19(3). Clause 86 expressly applies to transfers into settlement and provides that, subject to certain exceptions, the disposal and acquisition of the assets if made otherwise than by way of bargain at arms length shall be deemed to be for a consideration equal to the market value of the assets transferred.

The Bill further proposes that from 5th April, 1981, the roll-over general relief for gifts shall be available as between settlors and trustees. S. 79, Finance Act 1980 provides the relief but in its unamended form applies to gifts as between individuals only: it cannot, therefore, apply to a gift as between a settlor and trustees, the trustees not being 'individuals'.

DISPOSALS BY THE TRUSTEE DURING THE COURSE OF ADMINISTRATION OF THE TRUST

Subject to certain exceptions, a body of trustees is treated for capital gains tax purposes as a person who is chargeable to tax in the usual way in respect of chargeable gains accruing on the disposal of assets. It was mentioned earlier that disposals by a body of trustees may be actual or deemed;[3] however, the nature of the disposal does not affect the means of calculating any chargeable gain or allowable loss.

1. See McCutcheon: "Turtle Soup and Sales into Settlements": [1978] B.T.R. 381.
2. See Clause 74, Finance Bill 1981.
3. Supra, at p. 154.

Trustees are entitled to an exemption from tax in respect of the first £1,500 of their chargeable gains[1] but are not entitled to the roll-over general relief for gifts under s. 79, Finance Act 1980 which is available to individuals who deal otherwise than at arms length.

On two occasions the trustees may be deemed to have disposed of the settled property. There is a deemed disposal on the termination of a life interest in possession in the settled property, and on the occasion that a person becomes absolutely entitled to any settled property as against the trustee.

<u>a) S. 55 - the deemed disposal on the termination of a life interest in possession in settled property</u>

S. 55 applies on the termination of a life interest in possession. A life interest in possession includes an interest pur autre vie but does not include a right which is contingent upon the exercise of a discretion in any person.[2] An annuitant under a settlement has a life interest for the purposes of the section only if settled property has been appropriated by the trustees as a fund out of which the annuity is payable and there is no right of recourse to the settled property itself or to any income arising from settled property which has not been appropriated. The settled property appropriated for the payment of the annuity is treated as property under a separate settlement.[3]

It is perhaps regrettable that the phrase 'life interest in possession' is not further defined. The interpretation of the phrase 'interest in possession' has caused some considerable difficulty in relation to capital transfer tax. For the present purpose it will suffice to say that an interest in possession in settled property is a present right of present enjoyment of the property, unlike an interest which

1. Schedule 1 para 6.
2. S. 55(4).
3. S. 55(5).

is in remainder, in reversion or in expectancy.[1] A more elaborate analysis of the phrase is provided in the discussion of the capital transfer taxation of settlements.[2]

In the case of a life interest in, or in the income arising from, part of the settled property, that part is treated as the property of a separate settlement.[3]

In Pexton v. Bell[4] it was held that an interest in an undivided share is an interest in part of the settled property. The trustees held a single fund for four beneficiaries; the fund was neither divided into shares nor appropriated to the various beneficiaries. One of the beneficiaries died thereby causing a deemed disposal by the trustees under s. 55(1).

The Crown argued that the trustees were deemed to dispose of the entire settled property; the fund was undivided and, therefore, the deceased beneficiary had during his life an interest in each and every part of the settled fund.

Sir John Pennycuick explained the difficulty surrounding the nature of an undivided share:

> "The difficulty, I suppose, arises from the curious nature of an undivided share. Where property is held in undivided shares, each tenant in common has an interest in the whole of the property concerned but his interest is confined to a proportionate share of that property. He has an interest in every asset of the fund, but his co-tenants have equally a concurrent interest in every asset of the fund, and the true result is that each tenant in common is only the beneficial owner of a rateable share of the fund. In the present context it seems to me altogether more natural to look at the true position rather than at refinements of the law of property in this connection."[5]

1. See Whiteman and Wheatcroft, at 9:97.- 9:102.
2. Infra, at p. 199.
3. S. 55(6).
4. (1976) 51 T.C. 457, heard in tandem with Crowe v. Appleby.
5. Ibid., at p. 482-483.

The Crown's contention was rejected: the interest of the beneficiary was in part of the settled property, as Lawton, L.J. laconically demonstrated:

> "I have asked myself a series of questions ... Did [the deceased beneficiary] have a life interest in possession of the settled property? The answer clearly is: she had. Did she have that interest in all the settled property? By the standards of anyone other than a conveyancer the answer I am sure would be "No". If she had not got an interest in all the settled property, what had she got an interest in? - and the answer is: a part."[1]

In the event of the termination of a life interest in possession in all or part of the settled property, there is a deemed disposal by the trustee and an immediate reacquisition by him of the property which does not cease to be settled property.[2] Thus, there may be an adjustment in the base value of the settled property with the possibility of a chargeable gain or allowable loss accruing to the trustee. However, if the interest terminates by reason of the death of the tenant for life, any capital gain accruing to the trustee as a result of the deemed disposal is not a chargeable gain.[3]

In the circumstances described in s. 55(2) there is no deemed disposal under s. 55(1). S. 55(2) provides:

> "Subsection (1) above shall not apply on the occasion of the termination of the trusts of the settlement as respects any part of the settled property by the exercise of a power for that purpose contained in the settlement or of a statutory power of advancement or by the surrender of a life interest in such a part for the purpose of advancement, if all the property as respects which the life interest terminates thereby ceases to be settled property under the settlement."

1. Ibid., at p. 488.
2. Ibid., at p. 488.
3. S. 56(2). On the death of an annuitant who has no life interest, s. 55(1) applies as it does on the death of a tenant for life - s. 57.

The subsection was introduced by the Finance Act 1966 largely as a result of the efforts of Sir Hugh Lucas-Tooth. Sir Hugh was particularly concerned that an advancement made in the course of the administration of a settlement should not be an event occasioning a charge to capital gains tax.[1]

Subsection (2) applies where on the termination of the trusts of a settlement by reason of the exercise of a power of advancement or the surrender of a life interest, the settled property does not cease to be settled property but does cease to be settled property under the settlement. Thus it would appear that s. 55(2) is intended to prevent a deemed disposal by the trustee on the occasion that a life interest in the settled property terminates by reason of a surrender or advancement and the property as respects which the life interest terminates remains settled property but passes into a separate settlement.

It is doubtful if s. 55(2) has given effect to the intention of Parliament. The subsection may in the events prescribed prevent a deemed disposal under s. 55(1), but the trustee of the separate settlement will become absolutely entitled as against the trustee of the original settlement thereby causing a deemed disposal under s. 54(1).[2]

A less fundamental criticism of s. 55(2) is that it provides no means of ascertaining the base value of the advanced property for the purpose of a future disposal thereof by the trustee of the separate settlement into which it is transferred.

b) S. 54 - the deemed disposal on the occasion that a person becomes absolutely entitled to any settled property as against the trustee.

The trustee is deemed to dispose of and immediately reacquire any settled property on the occasion that a person becomes absolutely

1. Official Report, 13th July, 1966; Vol. 731 c. 1667. See also The Times (letters to the Editor) Friday 29th October, 1965 - 'Tax on Trust.'
2. This point is taken up below at p. 167.

entitled to that property as against the trustee.[1] The consideration for the disposal and reacquisition is equal to the market value of the disposed settled property. The trustee reacquires the property in the capacity of a trustee within s. 46(1).[2]

The deemed disposal marks the exit of the property from the scheme of trust taxation. Because the trustee reacquires in the capacity of a s. 46(1) trustee, the property is no longer settled property within the meaning of s. 51. The base value of the property is fixed for a future disposal by the person who becomes absolutely entitled as against the trustee.

No chargeable gain accrues to the trustee if the deemed disposal under s. 54(1) arises by reason of a person becoming absolutely entitled on the death of the tenant for life.[3]

Any allowable loss which accrued to the trustee in respect of the settled property and which cannot be deducted from any chargeable gain is treated as an allowable loss of the person who becomes absolutely entitled to the property as against the trustee. An allowable loss in respect of the settled property includes any loss carried forward under s. 4(1)(a) to the year of assessment in which the person became so entitled.[4]

A person may become absolutely entitled to property as against the trustee by virtue of the operation of the rule in Saunders v. Vautier.[5] As Monroe demonstrated, the combined effect of the rule in Saunders v. Vautier and s. 54(1) may be curious.[6]

1. S. 54(1). In clause 83, Finance Bill 1981 it is proposed that there should be a deemed disposal under s. 54 on the occasion that a person would become absolutely entitled as against the trustee but for that persons infancy or other disability.
2. S. 54(1).
3. S. 56(1). S. 54(1) applies on the death of an annuitant who has no life interest as it does on the death of a tenant for life - s. 57.
4. s. 54(2).
5. (1841) 49 Eng. Rep 282, supra, at p. 39.
6. "Associated Operation": [1968] B.T.R. 57.

If a fund is held in trust for such of the children of X who should attain the age of twenty-one years, although X may be seventy years old, her children in whom the fund has not absolutely and indefeasibly vested are not entitled to invoke the rule in Saunders v. Vautier for there is always the possibility that another child may be born: it being an established principle that a woman is never presumed to be beyond the age of child bearing.[1] But what if X were to undergo an hysterectomy? She would be physically incapable of conceiving another child: logically at the moment the surgeon completed the operation and X became irreversibly sterile there should be a deemed disposal of the trust fund under s. 54, the children becoming absolutely and indefeasibly entitled to the funds by virtue of the operation and of the operation of the rule in Saunder v. Vautier. However, as Monroe observed, the law does not always follow logic:

> "The law seems to consider that strictly speaking the age of miracles is still with us and ever mindful of the case of Abraham and Sarah[2] to proceed on the basis that all things are possible."[3]

S. 54 and resettlements

Extreme caution is required if a charge to capital gains tax is to be avoided on the advancement of property from one settlement into another. McCutcheon explained:

1. In Scotland there is a rebuttable presumption that a woman over fifty-three years old is incapable of child bearing. The presumption will not arise if the rights of parties other than the possible issue might be affected: G's Trustees v. G., 1939 S.C. 837. In Monro's Trustees v. Monson, 1965 S.C. 84, it was considered so improbable that males of eighty-one and seventy-six years could produce off-spring that the trustees were entitled to denude in favour of beneficiaries who were prepared to indemnify them against the claims of any prospective issue: see generally Walker, at p.2009.
2. Genesis xvii, 17.
3. [1968] B.T.R. 57, at p. 58.

"The most obvious way that the effect of a resettlement is important for capital gains tax purposes is that, if there is a new settlement, there may be a deemed disposal under section 54, Capital Gains Tax Act 1979, the trustees of the new settlement having become absolutely entitled against the trustees of the original settlement: see Hoare Trustees v. Gardner. If, on the other hand, the original settlement remains in tact, the trustees of the sub-settlement and the trustees of the head settlement will be treated as a single and continuing body under section 52 of the Capital Gains Tax Act 1979, and consequently there will not be a deemed disposal under section 54."[1]

The difficulties which have arisen have been in the main associated with the exercise of powers of appointment and advancement. The root of the problem lies in determining whether the property advanced or appointed remains the property under the original settlement or whether it becomes the subject matter of an entirely new and distinct settlement.

The traditional approach developed principally in relation to the law of perpetuities is that a trust declared by the exercise of a special power takes effect from, and must be read back into the original settlement. However, a trust declared pursuant to a general power takes effect from the moment of its constitution; it is a separate entity the trustees of which are distinct from the body of trustees of the original settlement. Lord Romer in Muir v. Muir propounded the rule thus:

" ... if a person be given a general power of appointment over certain property he is virtually the owner of that property. If and when he exercises the power the interests of his appointees come to them by virtue of and are created by the deed of appointment. In the case of a special power it is very different. If, for example, property be settled on trust for A for life and after his death on trust for such of A's children or remoter issue and in such proportions as B shall by deed appoint, B has no interest in the property whatsoever. He has merely been given the power of saying on behalf of the settlor which of the issue of A shall take the property under the settlement and in what proportions. It is as though the settlor had left a blank in the settlement which B fills up for him if and when the power of appointment is exercised. The appointees' interests come to them under the settlement alone and by virtue of that document."[2]

1. "Resettlements: A Muddle": /‾1980_7 B.T.R. 174, at p. 179.
2. /‾1943_7 A. C. 468, at p. 483. See also In Re Pilkington's Will Trusts, /‾1964_7 A. C. 612.

The approach adopted in Muir v. Muir has not been strictly implemented by the courts in relation to capital gains tax cases. In Hart v. Briscoe Brightman, J. noted:

> "In my judgement, the question whether a disposition which exercises a fiduciary power is to be viewed as a separate settlement, or as part of a single fiduciary arrangement headed by the disposition which created the power, must be answered in the context of the circumstances of the particular case."[1]

Brightman, J. considered it possible that a new settlement could be created on the exercise of a special power. He suggested that if the exercise of such a power did nothing more than to vary the age of vesting or alter the shares of contingent beneficiaries, then no new settlement would have been created; but he continued:

> "If, however, a special power of appointment, drawn in an appropriately wide form, is so exercised that the appointed assets become vested in distinct trustees, and all the trusts, powers and provisions of the original settlement are irrevocably gone, completely new trusts, powers and provisions being created to take their place, so that no one will ever again need to refer to the original settlement except to confirm that it has ceased to exist, the trustees of the original settlement being functus officio and having nothing whatever to do, I would find it difficult to believe that the original settlement continues in being, whether one uses the word "settlement" in the sense of a trust instrument or in the sense of a series of trusts."[2]

The problem was recently considered by the House of Lords in Roome v. Edwards, where Lord Wilberforce noted:

> "There are a number of obvious indicia which may help to show whether a settlement, or a settlement separate from another settlement, exists. One might expect to find separate and defined property; separate trusts; and separate trustees. One might also expect to find a separate disposition bringing the separate settlement into existence. These indicia may be

1. (1977) 52 T.C. 53, at p. 73.
2. At p. 73.

helpful, but they are not decisive. For example, a single disposition, e.g. a will with a single set of trustees, may create what are clearly separate settlements, relating to different properties, in favour of different beneficiaries, and conversely separate trusts may arise in what is clearly a single settlement, e.g. when the settled property is divided into shares. There are so many possible combinations of fact that even where these indicia or some of them are present, the answer may be doubtful, and may depend on an appreciation of them as a whole.

"Since 'settlement' and 'trust' are legal terms, which are also used by business men or laymen in a business or practical sense, I think that the question whether a particular set of facts amounts to a settlement should be approached by asking what a person, with knowledge of the legal context of the word under established doctrine and applying this knowledge in a practical and commonsense manner to the facts under examination, would conclude."[1]

The deliberation of the House of Lords on the matter is far from satisfactory. To determine whether or not a separate settlement has been created it would appear to be no longer necessary to consider the traditional approach as expounded in Muir v. Muir; the issue must be determined as a question of fact.[2]

The real dilemma will be faced by trustees who wish to advance sums on trust but who do not wish to expose themselves to the risk of a charge to capital gains tax under s. 54(1). According to Walker:

"To have the best chance of avoiding a charge ... an advance by way of resettlement should, it seems,

(i) be expressed as an application of capital by appropriation on new trusts, rather than involving a transfer to a separate ad hoc settlement;
(ii) define the trustees (in relation to the new trusts) as the trustees or trustee for the time being of the head settlement;
(iii) avoid conferring new investment powers and other administrative powers, and instead expressly incorporate those of the head settlement (so far as consistent with the beneficial trusts); and
(iv) if acceptable for income tax and capital transfer tax, deliberately fail to exhaust the beneficial interest completely; so as to make it necessary to refer back to the head settlement

1. [1981] S.T.C. 96, at p. 100.
2. See generally Pettit, "An Alarm Bell Sounds for Trustees": (1981) 131 N.L.J. 352.

to discover the effective ultimate trust."[1]

A charge to capital gains tax will arise by reason of a resettlement only if the new trustees become absolutely entitled to the settled property as against the original trustees. It is in this context that the distinction noted earlier[2] between the concepts of 'beneficial entitlement' and 'absolute entitlement as against the trustee' is of significance.

In Hoare Trustees v. Gardner,[3] the trustees, pursuant to a power contained in the main settlement, declared that they would hold certain assets on trusts other than those of the main settlement. The trusts declared exhausted the entire beneficial interest in the assets: there was no possibility that the assets could result back to be held according to the terms of the main settlement. Brightman, J. held that on the exercise of the power there was created a new settlement the trustees of which were absolutely entitled to the assets as against the trustees of the main settlement. There was, therefore, a deemed disposal under s. 54(1):

> "Section [46(1)] shows beyond doubt that ... 'absolutely entitled' is not identically the same as 'beneficially entitled', for the subsection is drawn on the footing that an infant who is an absolute beneficial owner of property held in trust does not, apart from specific provision in the subsection, qualify as a person absolutely entitled as against the trustee. Furthermore, if "absolutely entitled" is confined to absolutely entitled in a beneficial sense, then the words "as against the trustee" are meaningless because they add nothing. An absolute beneficial owner of property held in trust is absolutely entitled as against the whole world, not merely as against his trustee: he cannot have absolute beneficial ownership as against some persons and not others."[4]

1. "Capital Gains Tax on Advances": [1978] B.T.R. 118, at p. 121-122. Walker's opinion is apparently unaffected by the House of Lords decision in Roome v. Edwards.
2. Supra, at p. 155.
3. (1977) 52 T.C. 53.
4. Ibid., at p. 76.

The decision of Brightman, J. in the Hoare Trustee case has attracted considerable criticism. Walker noted:

> "It may be urged that the judge attached too much weight to the words "absolutely entitled as against the trustee" (words which were, he said, meaningless if only absolute beneficial entitlement was intended): perhaps these words can be adequately explained either (i) as an attempt to convey the meaning of "indefeasibly" in non-technical language; or (ii) as emphasising the contrast made in section [54(1)] between the termination of the fiduciary owner's capacity as an ordinary trustee and the commencement of his capacity as a nominee (or bare trustee) with [s.46(1)]. It may also be urged that the judge attached too little importance to the natural meaning of "absolutely ... ". [1]

Support for Walker's argument is found in Whiteman and Wheatcroft,[2] though, unfortunately, this support is based partly on a now overruled aspect of the Court of Appeal's decision in Roome v. Edwards. Furthermore, in the House of Lords decision in Roome v. Edwards Lord Wilberforce endorsed in principle the decision in Hoare Trustees v. Gardner. He suggested that on the creation of a separate settlement of part of the settled property it would seem inescapable that 'there would be a deemed disposal under [s. 54(1)] of that part in favour of the trustees of that part (even though they might be the same persons as the trustees of the original settlement, their personality being irrelevant, under [s. 52(1)].'[3]

In the criticism of the Hoare Trustees case in Whiteman and Wheatcroft attention is focused on s. 55(2).[4] It was demonstrated above that the intention of Parliament on introducing s. 55(2) was to prevent a charge to capital gains tax on the advancement of settled into a separate settlement.[5] The subsection serves no purpose whatever if there is a charge under s. 54(1) by reason of the new trustees becoming absolutely entitled to the advanced property as against the original trustees. In view of the dicta of Lord Wilberforce in Roome v. Edwards, it has become increasingly difficult to question the validity of the

1. "Capital Gains Tax on Advances" 1978 B.T.R. 118, at p. 119.
2. 9:74-75.
3. [1981] S.T.C. 96, at p. 101.
4. 9:75 (footnote 64).
5. Supra, at p. 165.

decision in the Hoare Trustees case: thus, it would appear that s. 55(2) is now redundant. S. 55(2) is effective only if the Hoare Trustees case is considered to be wrongly decided.

THE DISPOSAL OF AN INTEREST IN SETTLED PROPERTY

Consonant with the theory that the liability to tax tends to follow the legal ownership of the trust fund, s. 58(1) provides that no chargeable gain accrues to a beneficiary on the disposal of an interest created or arising under a settlement.[1]

An interest which is acquired for consideration in money or money's worth (other than consideration consisting of another interest under the settlement) or is derived from a person who so acquired the interest, is treated as an asset on the disposal of which a chargeable gain may accrue.[2] On the occasion that a person who holds such an interest becomes absolutely entitled to the property as against the trustee, that person is treated as having disposed of his interest in consideration of his obtaining the property. However, this does not affect the operation of s. 54(1) in respect of the deemed disposal by the trustee.[3]

Clause 84 of the Finance Bill 1981 proposes certain amendments in respect of disposals of interests in non-resident settlements. The clause is directed at a particular form of tax avoidance involving a combination of the exemption under s. 58 and the immunity to capital gains tax of non-residents.

1. In this respect it is necessary to distinguish the interests under a settlement from the settled property itself. In Harthan v. Mason, [1980] S.T.C. 94, tenants in common held land for themselves on statutory trusts. The land was sold and the tenants in common claimed that the gain thereby accruing to them was not chargeable to tax; they argued that they had disposed of their interests under the statutory trust and the gain, therefore, was exempt under s. 58(1). Fox, J. held that the gain accrued by reason of a disposal of the land and not of the beneficial interests therein; he held that the beneficial interests both before and after the disposal were in the proceeds of sale (at p. 97).
2. S 58(1).
3. S. 58(2).

S. 2(1) provides that a person is chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident or ordinarily resident in the United Kingdom. Thus a trustee who is resident outwith the United Kingdom cannot be assessed to tax in respect of capital gains accruing to him.[1] However, under s. 17 the gain may be attributed to a United Kingdom resident beneficiary.

S. 17 applies to any settlement created by a settlor who is domiciled and resident or ordinarily resident in the United Kingdom, the administration of which is carried on by trustees who are not resident or ordinarily resident in the United Kingdom. Should the trustees realize a gain which would have been chargeable had they been domiciled and resident or ordinarily resident in the United Kingdom, then the gain may be apportioned to any United Kingdom domiciled and resident beneficiary; the beneficiary will be assessed to tax accordingly. The apportionment must be made in a manner which is just and reasonable, having regard to the extent of the beneficiary's interest.[2]

Thus, non-resident trustees and non-resident beneficiaries are immune to capital gains tax.

It was demonstrated in Berry v. Warnett[3] that these immunities coupled with the exemption under s. 58(1) could be manipulated to the advantage of the taxpayer. It will be recalled that in Berry v. Warnett the taxpayer constituted a settlement for full consideration. He transferred shares to a non-resident trustee and, having reserved for himself a life interest, sold the remainder to a non-resident company so effecting a part disposal.[4] The scheme was completed when

1. Resident trustees of a settlement may be assessed to tax in respect of gains accruing to non-resident trustees of the same settlement - s. 52 as applied in Roome v. Edwards, [1981] S.T.C. 96.
2. Clauses 76-79, Finance Bill 1981 propose substantial amendments to the means of attributing the gains of non-resident trustees to resident beneficiaries.
3. [1980] S.T.C. 631.
4. Supra, at p. 160.

the taxpayer assigned his life interest to another non-resident company thereby realizing a gain which, in accordance with s. 58(1), was not chargeable. The taxpayer successfully disposed of his entire interest in the shares and in doing so attracted a charge to tax on the basis that he had made a part disposal only.

In Chinn v. Collin,[1] United Kingdom resident trustees held shares in L Ltd. on discretionary trust. In order to avoid a charge to capital gains tax on the occasion that A, a discretionary object, became absolutely entitled to the shares in L Ltd., the following steps were taken: (1) the administration of the trust was transferred to non-resident trustees; (2) on 28th October, 1969, the trustees declared that they held 184,500 of the shares for A absolutely contingently upon his surviving three days; (3) also on 28th October, 1969, A sold his contingent interest to a non-resident company, R Ltd., for £352,704; and (4) on the same day A agreed to purchase from R Ltd. 184,500 shares in L Ltd. for £355,162, the sale to be completed on 1st November, 1969.

The theory was that by selling his contingent interest, by virtue of s. 58(1) the gain thereby realized would not be chargeable. R. Ltd. would become the beneficiary under the settlement and on the 1st November, 1969, would become absolutely entitled to the shares as against the trustee. There would be no charge on that occasion as both the trustee and beneficiary would be resident outwith the United Kingdom. A would then receive the shares from R Ltd. pursuant to the sale agreement.

The scheme failed. Although it was not stipulated in the contract that A should receive the same shares to which R Ltd. would become absolutely entitled on 1st November, 1969, this much could be implied. As Lord Wilberforce indicated, 'If an agreement can only be carried out in one way it is superfluous to mention that one way specifically in the agreement: the parties are presumed to intend it.'[2] According to Lord Wilberforce:

1. [1981] S.T.C. 1.
2. Ibid., at p. 7.

"As soon as there was an agreement for their sale accompanied or followed by payment of the price, the equitable title passed at once to the purchaser, viz [A], and all that was needed to perfect his title was notice to the trustees ... which [they] had at all material times. Consequently the trustees were bound to transfer the shares to [A] immediately the interests vested on 1st. November, 1969, and [A] was the beneficiary, under the settlement as regards the shares."[1]

The Crown also urged that the whole arrangement was a "settlement" within the meaning of s. 17(7), under which A was a beneficiary. The arrangement involved an element of bounty in that the trustee exercised its power of appointment gratuitously[2] and in doing so conferred completely part of the bounty which had been incompletely provided by the settlor on constituting the discretionary trust in the first place.[3] On this ground alone it would have been possible to attribute a chargeable gain to A under s. 17(2).

There can be little doubt that had A merely assigned his interest to R. Ltd. without entering into the share sale agreement, A would have secured a sum approximately equal to the value of the shares and would have avoided a charge to tax.[4]

Clause 84, Finance Bill proposes that, from 10th March, 1981, s. 58(1) shall not apply to the disposal of an interest in settled property if at the time of the disposal the trustees are neither resident nor ordinarily resident in the United Kingdom. The clause further provides that if at any time after a beneficiary disposes of his interest the trustees cease to be resident or ordinarily resident in the United Kingdom, a chargeable gain shall be deemed to accrue to the trustees immediately before the administration of the settlement is transferred to non-residents. The amount of the gain deemed to accrue to the trustees is to be equal to the gain accruing to the beneficiary on the disposal of his interest.

1. Ibid., at p. 7.
2. Per Lord Roskill at p. 200.
3. Per Lord Wilberforce at p. 196.
4. The immunity to capital gains tax of non-residents and the exemption under s. 58 also formed the basis of the unsuccessful scheme in Eilbeck v. Rawlings, [1981] S.T.C. 174. The schemes were reviewed by Foreman, "Capital Gains Tax and Settled Property": (1981) 106 Taxation 666, at p. 669-671.

Assuming that the proposal in clause 84 is incorporated in the Finance Act 1981, the avoidance mechanism at the heart of the schemes in Berry v. Warnett and Chinn v. Collins will be effectively destroyed.

CONCLUSION

The person who may be liable to capital gains tax in respect of settled property will usually be the trustee as legal owner of the fund; it is immaterial to whom the income of the trust is paid.[1]

Unless the settled property is at all times composed of cash, the imposition of capital gains tax certainly renders less attractive the income tax advantages associated with a settlement of capital.

The disposal on the creation of the settlement and, in particular, the deemed disposals by the trustees diminish to a considerable extent the real fiscal benefits of an income tax effective settlement.

Perhaps one of the greatest attributes of the trust as a means of saving tax namely, its flexibility, has been limited in consequence of the uncertainty surrounding advancements, appointments and resettlements in general. This does not affect the income tax saving efficiency of the trust, though as a result the trust becomes a less desirable option available to the tax planner.

1. Tiley, 24:01. It may be of importance to ascertain to whom the income is paid for the purpose of determining whether a life interest 'in possession' exists in the settled property.

CAPITAL TRANSFER TAX [1]

Introduction

It was the intention of Parliament on devising the scheme of taxation of capital transfers that there should be no discrimination as between settled property and property held absolutely. The White Paper on capital transfer tax provided:

> "The broad principle to be applied to settled property is that in general the charge to tax should be neither greater nor smaller than the charge on property held absolutely."[2]

The objective of Parliament has been met by the Finance Act 1975 and its various amendments with a limited degree of success. The Inland Revenue have commented that the principle recited in the White Paper is easier to state than to carry out in practice and demonstrate generally that the implementation of the principle has been far from satisfactory.[3]

It is noted in Hayton and Tiley that a separate capital transfer tax charging code for settlements is necessary to restrict the scope for postponing and minimising a charge to capital transfer tax by means of a settlement.[4] The code is substantially embodied in Schedule 5 to the Finance Act 1975:[5] the Schedule is in the nature of anti-avoidance legislation and this to a certain extent explains why the actual implementation of the principle recited in the White Paper has in practice tended to discriminate against settled property.[6]

1. Unless otherwise stated, references are to the Finance Act 1975, and references to paragraphs are to the paragraphs of Schedule 5 to the Finance Act 1975.
2. Cmnd. 5705, para. 17.
3. "Capital Transfer Tax and Settled Property (a consultative document)", para 2.3.1.
4. P. 76.
5. Schedule 5 is given effect by s. 21.
6. An abundance of evidence of this discrimination is provided in the Inland Revenue's consultative document.

Schedule 5 provides the actual mechanism for the charging of settlements to capital transfer tax. The machanism consists of two essentially independent components, one dealing with settled property in which there subsists an interest in possession, the other relating to settled property in which no interest in possession subsists. Before detailing the scheme of settlement taxation it will be useful first to consider the meaning of the terms "settlement", "settlor", "trustee" and "excluded property" for the purposes of Sch. 5.

A settlement for the purposes of capital transfer tax is any disposition of property, the property being:

> "(a) held in trust for persons in succession or for any person subject to a contingency; or
> (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income; or
> (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition), with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period;
>
> or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom; ... "[1]

In Scotland, "settlement" also includes an entail; any deed charging an annuity on, or on the rents of, any property; and any deed creating or reserving a proper liferent of any property.[2]

The word "settlor" is defined is similar terms as it is in Part XVI, I.C.T.A. Thus "settlor" includes 'any person by whom the settlement was made directly or indirectly', or 'who has provided funds directly

1. Para. 1 (2). "Settlement" also includes a lease for lives - para. 1(3).
2. Para. 1(4).

or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement.'[1]

The judicial decisions discussed earlier in respect of the term "Settlor" as used in Part XVI, I.C.T.A. are to a certain extent relevant here, though their value is dubious for the reason that the word "settlement" in Part XVI is assigned a wider meaning than it is in Sch. 5.[2]

"Trustee" is not defined for the purposes of Sch. 5. However, in the case of a settlement in relation to which there is no trustee, under para. 1(7) the person in whom the settled property or its management is vested is treated as the trustee.

"Excluded property" for the purposes of Sch. 5 is any property outside the United Kingdom which is comprised in a settlement unless the settlor was domiciled in the United Kingdom when the settlement was made.[3] A reversionary interest[4] in such property is excluded property only if the person who is beneficially entitled to the reversionary interest is an individual domiciled outside of the United Kingdom.[5]

1. Para. 1(6).
2. Dymond, at p. 552.
3. Para. 2(1).
4. "Reversionary interest" means a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the termination of an interest in possession which by virtue of Paragraph 3 of Schedule 5 ... is treated as subsisting in part of any property) and in relation to Scotland includes an interest in the fee of property subject to a proper liferent." - s. 51(1).
5. Para. 2(1)(a) and (b).

A reversionary interest in settled property situated in the United Kingdom is excluded property unless (a) it was acquired for a consideration in money or money's worth, or was derived from one who so acquired it; (b) it is one to which the settlor or his spouse is entitled; or (c) it is the interest expectant on the determination of a lease treated as a settlement by virtue of para. 1(3) of Sch. 5.[1]

THE CHARGE TO CAPITAL TRANSFER TAX ON THE CREATION OF A SETTLEMENT

The scheme of taxation provided by Sch. 5 operates in respect of settlements; however, the creation of a settlement is governed by the ordinary capital transfer tax rules. Thus the settlor is charged to tax on any diminution in the value of his estate caused by his constituting the settlement. The property transferred into the settlement enters into the settled property regime of Sch. 5. Its treatment from thenceforth depends upon whether or not there subsists an interest in possession under the settlement.

It will be convenient first to consider the two schemes of taxation of settled property before discussing the nature of an interest in possession.

SETTLED PROPERTY IN WHICH THERE SUBSISTS AN INTEREST IN POSSESSION

Trusts comprising settled property in which there subsists an interest in possession are described in the report of the Meade Committee as 'transparent'; tax is charged 'by reference to the personal circumstances of the beneficiary as if the trust did not exist.'[2] Para. 3(1) forms the basis of this submission and provides that 'A person beneficially entitled to an interest in possession in settled property shall be treated as beneficially entitled to the property in which his interest subsists.'

1. S. 24(3).
2. "The Structure and Reform of Direct Taxation", at p. 401.

Provision is made for the circumstance where the beneficiary is entitled to part only of the income arising from the settled property[1] or where his entitlement is to a specified amount of that income.[2] In general the effect of these provisions is to treat the beneficiary as being beneficially entitled to such a part of the settled property that will generate sufficient income to satisfy his entitlement according to the terms of the trust. An apportionment is also made where the beneficiary is not entitled to the income from the settled property but is entitled to the use and enjoyment of the property either jointly or in common with other persons.[3]

It is apparent that by the fiction of para 3(1) the value of the beneficiary's estate is made artificially high; the actual value of his interest will in most circumstances be considerably less than the value of the property in which his interest subsists.[4] However, consistently with the fiction, there can be no charge to tax on the occasion that the beneficiary's interest is enlarged to an absolute entitlement to the property itself. Further, it is doubted if the granting of an interest-free loan of capital to the beneficiary can constitute a chargeable event, unless it can be considered as a transaction reducing the value of the settled property which is an event chargeable under para. 4(9) of Sch. 5.[5]

1. Para. 3(2)
2. Para. 3(3).
3. Para. 3(5).
4. Consultative document, para. 3.2.5.
5. Foster, C2.04(c). para. 4(9) provides that where, as a consequence of a transaction made between the trustee and, inter alia, the beneficiary under the trust, the value of the settled property is diminished, a corresponding part of the beneficiary's interest is treated as coming to an end; an event which is chargeable under para. 4(2) as described below. However, as McCutcheon indicated a loan which is repayable on demand will not depreciate the value of the trust fund: /¯1979_/ B.T.R. 246, at p. 246.

On the death of the beneficiary the settled property is treated under s. 22(1) as if it were a part of the beneficiary's free estate, although the trustees will usually be liable for the tax in respect of it.

Sch. 5 provides an elaborate scheme to deal with the event of the termination of the beneficiary's interest during his life. Para 4(2) provides:

> "Where at any time during the life of a person beneficially entitled to an interest in possession in any property comprised in a settlement his interest comes to an end, tax shall be charged, subject to the following provisions of this paragraph, as if at that time he had made a transfer of value and the value transferred had been equal to the value of the property in which his interest subsisted."

It is immediately noticeable that para 4(2) represents a departure from the 'consequential loss formula' of s. 20 which is applicable to life time transfers of property held absolutely. As a corollary, there is no requirement to gross up the value of the settled property in order to calculate the amount on which tax is chargeable.

The trustees will usually be responsible for the tax chargeable in the event of the termination of the beneficiary's interest; however, the 'transfer' will adversely affect the beneficiary's cumulative total. This fact must be borne in mind by trustees on making advances to persons other than the beneficiary entitled to the interest in possession. It would appear that such an advancement will constitute the coming to an end of the beneficiary's interest in the property advanced. This inevitably will increase the beneficiary's cumulative total.[1]

1. An advancement made by virtue of the statutory power contained in s 32, Trustee Act 1925 will invariably require the written consent of the beneficiary who is entitled to the interest in possession: - s. 32(1)(c).

Para. 4(1) provides that on the disposal of the beneficiary's interest, tax is to be charged not as if he had made a transfer of value, but as if his interest in the property had terminated; an event chargeable under para 4(2) as described above. It is suggested in Foster that this 'apparently circular treatment is to convert an actual transfer of value into a deemed one with the result that the exemptions for gifts of £2,000 per annum, /¯£250_7 per donee, normal expenditure out of income and in consideration of marriage, do not apply.'[1] However, should the beneficiary dispose of his interest for a consideration in money or money's worth, the value of the property in which the interest subsists is treated as having been reduced by an amount equal to the consideration received.[2]

There is an exemption to tax where during the life of the beneficiary his interest terminates and the property reverts to the settlor if living, or to the settlor's spouse if domiciled in the United Kingdom. This exemption is subject to the proviso that neither the settlor nor his spouse must have acquired the reversionary interest for a consideration in money or money's worth.[3] The exemption is of little practical value to those who hope to avoid payments of income tax by means of a settlement of capital: a possible reversion of the settled property to the settlor or his spouse might nullify the attempt of the settlor to divest himself absolutely of the capital for the purpose of s. 457(1)(d), I.C.T.A.

There is a limited relief in the circumstances that the value transferred by a chargeable transfer is calculated by reference to the value of settled property in which there subsists an interest in possession.[4] Clause 95, Finance Bill proposes certain amendments in this respect. It proposes that the relief should be available where there has been a previous chargeable transfer of the settled

1. C2.03, at C134.
2. Para. 4(4).
3. Para 4(5) and (6): see also clause 98, Finance Bill 1981.
4. Para. 5.

property (the first transfer) which increased the value of a persons estate and which was made either on or after the constitution of the settlement.

If the period between the two transfers is less than five years, then the amount of tax chargeable on the value transferred by the later transfer may be reduced. The reduction is expressed as a percentage of the tax paid on the first transfer as is attributable to the increase in value of the first beneficiary's estate.

The percentage is 100% if there is a period of less than one year between the first and later transfer; 80% if the period is more than one year but less than two; 60% if more than two years but less than three; 40% if more than three years but less than four; and 20% if more than four years but less than five.[1]

Clause 95(4) proposes a limited carry-forward of the relief to subsequent transfers. The Clause is intended to take effect from 10th March 1981.

It should be noted that no tax is chargeable under para. 4 if the settled property is excluded property.[2]

SETTLED PROPERTY IN WHICH NO INTEREST IN POSSESSION SUBSISTS

> "The main statutory provisions which charge tax under the discretionary trust regime, in particular those in paras 6 to 11 of Sched 5, may be regarded either as a masterpiece of subtle, intricate and esoteric logic, or as a monstrosity of repellant and well-nigh unfathomable convolution, according to taste; and probably most readers will prefer the latter description."[3]

A settlement in which there subsists no interest in possession (usually referred to as a discretionary or accumulation settlement)

1. The relief currently provided by para 5 is available in respect of a subsequent transfer made not later than four years after the first transfer. The relief operates by reducing the value of the property which is the subject of the subsequent transfer. The amount of relief available decreases as the number of years between the transfers increases.
2. Para. 11(4).
3. Dymond, at p. 651.

is, in essence, treated as an entity for the purposes of capital transfer tax. This is not strictly true of settlements constituted after 1974 as the rate at which these settlements are charged to tax may be determined by reference to the personal rate of tax of the settlor when he made the settlement.[1]

Fundamental to the scheme of taxation are the concepts of 'capital distribution' and 'distribution payment'. The expression 'capital distribution' according to Foster 'is used to denote that the transaction is liable to CTT, rather than to denote a type of transaction', whereas 'a distribution payment is something which enters into the settlement's cumulative total.'[2]

Distribution Payment

Para. 11(7) provides that a 'distribution payment' means:

> " ...any payment which -
> (a) is not income of any person for any of the purposes of income tax and would not for any of those purposes be income of a person not resident in the United Kingdom if he were so resident; and
> (b) is not a payment in respect of costs or expenses;
>
> and "payment" includes the transfer of assets other than money."

Thus, a payment of capital by the trustees which is treated as the income of any person, for instance, by virtue of the rule in Brodie's Will Trustees v. I.R.C.,[3] or by virtue of s. 438 or s. 451, I.C.T.A., will not constitute a distribution payment.

A distribution payment may be actual or deemed. There may be a deemed distribution payment under para. 11(8) which is discussed below.[4]

1. "The Structure and Reform of Direct Taxation", at p. 402.
2. Foster, C3.01 at C162.
3. (1933) 17 T.C. 432.
4. Infra, at p. 189.

Capital Distribution

There is provided no direct definition of a capital distribution. In para. 6(1) it is stated that a distribution payment made out of settled property in which no interest in possession subsists is referred to as a capital distribution; however, it is not legitimate to define a capital distribution in terms of a distribution payment. A capital distribution may be treated as having been made in circumstances where there is neither an actual nor deemed distribution payment.[1]

It is in respect of capital distributions alone that tax is charged under the regime for discretionary settlements. Para. 6(4) provides:

> "Tax shall be charged on any capital distribution as on the value transferred by a chargeable transfer where -
>
> (a) the value transferred less the tax payable on it is equal to the amount of the capital distribution; and
> (b) the rate applicable is that specified in paragraphs 7 to 9 below; ... "

It is noted in Dymond:

> "Paragraph 6(4) is in fact the only true charging provision under the discretionary trust regime: all other provisions which in substance impose a charge do so by treating a capital distribution as being made in specific circumstances, and so channel it back into para 6(4)."[2]

A thorough understanding of the interaction of the concepts of 'capital distribution' and 'distribution payment' can be achieved only by considering the consequences of the various chargeable events.

1. e.g. the periodic charge under para 12(1), at p. 194.
2. P. 651-652.

THE CHARGEABLE EVENTS UNDER THE DISCRETIONARY SETTLEMENT REGIME

A) Para. 6(1): distribution payments which are capital distributions

Para. 6(1) provides:

> "Where a distribution payment is made out of property comprised in a settlement and at the time the payment is made no interest in possession subsists in the property or in the part of it out of which the payment is made, the payment is in this Schedule referred to as a capital distribution."

Tax is charged on the capital distribution as described in para. 6(4)(a) at the rate applicable under paras. 7 to 9. If the recipient bears the tax, then by virtue of para. 6(5) tax is charged under para. 6(4) as on the value transferred by a chargeable transfer where the value transferred is equal to the amount of the capital distribution. There is no requirement to gross up the capital distribution to determine the value of the chargeable transfer.

A distribution payment to the settlor or his spouse does not constitute a capital distribution.[1] however, the distribution payment will affect the settlements cumulative total.[2]

Para 11(5) provides that, for the purposes of calculating the settlement's cumulative total, the amount of the distribution payment is the amount on which tax is paid: unless the recipient bears the tax that amount will be the grossed up amount of the capital distribution. Para. 11(5) provides:

> "The amount of any distribution payment which is a capital distribution shall be taken (except for the purpose of paragraph 6(4)(a)) to be the amount on which tax is chargeable in respect of it."

Thus, the amount on which tax is paid is the amount that enters into the settlement's cumulative total.

1. Para 6(6).
2. Obviously if the capital is treated as the income of the settlor under s. 451, I.C.T.A. it will not constitute a distribution payment - para. 11(7)(a).

An advancement of property into a separate settlement is not a capital distribution under para. 6(1); nor is it a distribution payment. This is because para. 11(4) provides that where property leaves one settlement and becomes comprised in another, it is treated as if it remained in the first. Many of the resettlement problems associated with capital gains tax are thereby avoided.[1]

B) Para. 6(2): the occasion on which a person becomes entitled to an interest in possession

Para. 6(2) provides:

> "Where a person becomes entitled to an interest in possession in the whole or any part of the property comprised in a settlement at a time when no such interest subsists in the property or that part, a capital distribution shall be treated as being made out of the property or that part of the property; and the amount of the distribution shall be taken to be equal to the value at that time of the property or if the interest is in part only of that property, of that part."

Under para. 6(4)(a) tax is charged on the amount of the capital distribution grossed up at the appropriate rate. However, the grossing up principle does not apply where the tax is payable out of the property which is the subject of the capital distribution.[2]

By virtue of para. 11(8), the amount of a notional capital distribution under para. 6(2) is to be treated as a distribution payment. This will affect the cumulative total of the settlement. Para. 11(8) provides:

> "The amount of any capital distribution treated as made under paragraph 6(2), (2A) or (3) above or paragraph 15(3) or 24(2) below shall also be deemed to be a distribution payment; but where, after an amount has been taken into account by virtue

1. Supra, at p. 167. However, para. 11(4) does not apply to settlement in which an interest in possession subsists: see generally McCutcheon, "Resettlements: A Muddle": [1980] B.T.R. 174.
2. Para. 6(5).

of this sub-paragraph or paragraph 6(6A) above as a distribution payment made out of the whole or part of any property, one or more distribution payments are made (otherwise than under this sub-paragraph or paragraph 6(6A) above) out of that property or part, the amount so taken into account shall be treated as reducing the amount of those payments."

It can only be assumed that para. 11(8) and para. 11(5) operate in conjunction. Thus the amount of the distribution payment deemed to have been made under para. 11(8) is ascertained by reference to para. 11(5). By virtue of para. 11(5), the amount of a distribution payment which is a capital distribution is taken to be the amount on which tax is charged. This ensures that the amount on which tax is charged is the amount that enters into the settlement's cumulative total.[1]

Para. 6(2) operates on the occasion that a person becomes entitled to an interest in possession; however, it is not clear which provision operates to treat as a chargeable event the occasion on which a person becomes absolutely entitled to property comprised in a settlement. The situation envisaged is the transfer of property to a beneficiary absolutely, but where before the absolute vesting of the property the beneficiary was entitled to a mere contingent interest which could not have constituted an interest in possession. An example of this would be the capital gains tax scheme in Chinn v. Collins.[2] It will be recalled that the scheme in Chinn v. Collins consisted of the appointment of property absolutely to a beneficiary contingent upon his surviving a specified time; a transfer of the trusteeship to non-residents followed by the assignation of the beneficiary's contingent interest to a non-resident for consideration. On the vesting of the property absolutely in the purchaser of the contingent interest there may have been a charge to capital transfer tax for which the settlor might have been liable under s. 25(3)(d)[3]. Beattie noted:

1. See McCutcheon, at 11-09 to 11-11.
2. [1981] S.T.C. 1, supra, at p. 175.
3. See Ballard: "Chinn v. Collins: Trusts and Tax Avoidance", CTT News, January, 1981, p. 15, at p. 19.

"On the termination of a discretionary trust by the vesting of the trust assets in a beneficiary taking absolutely, or in a purchaser of the beneficiary's interest taking absolutely, capital transfer tax would appear to be payable. There is some doubt whether it would be payable under subparagraph (2) of paragraph 6 of Schedule 5 to the Finance Act 1975, on the footing that the beneficiary or the purchaser became entitled to an interest in possession in the property comprised in a settlement or whether it would be payable under subparagraph (1) on the footing that a distribution payment was made out of property comprised in a settlement. There is a school of thought to the effect that no capital transfer tax at all would be payable if the actual payment to the beneficiary or the purchaser were to be deferred until after actual vesting, on the footing that the property was no longer comprised in a settlement when the beneficiary or the purchaser became entitled to the absolute interest in possession, so that subparagraph (2) of paragraph 6 would not apply, and that the distribution payment would not be made out of property comprised in a settlement, as the settlement would have come to an end, so that subparagraph (1) would not apply."[1]

Beattie favoured a charge under para. 6(1) on the basis that the absolute vesting would constitute a 'transfer of assets' which would be a distribution payment. His view is supported by dicta of Brown-Wilkinson, J. in Von Ernst Et Cie SA v. I.R.C. who stated:

"Counsel for the trustees concedes, I think, that a distribution payment out of property held on discretionary trusts to a beneficiary for an absolute interest would be an actual capital distribution under para. 6(1) which ... would inevitably attract tax under para. 6(4). This concession being rightly and, I think, inescapably made ..."[2]

However, the Inland Revenue have taken the view that the absolute vesting would be brought into charge by para. 6(2)

"The case where a beneficiary becomes entitled to an interest in possession in property previously held on discretionary trusts includes situations where the beneficiary becomes absolutely entitled to the settled property itself."[3]

1. "Foreign Trustees of Discretionary Trusts, Capital Gains Tax and Capital Transfer Tax", [1976] B.T.R. 16, at p. 17.
2. [1980] S.T.C. 111, at 117.
3. The Board of Inland Revenue booklet, CTT 1, para. 91.

It would appear that the absolute vesting of settled property will attract a charge to capital transfer tax be it by virtue of para. 6(1) or (2). In this respect it may be argued that the confusion as to which sub-paragraph is applicable is of mere academic significance. However, it would appear axiomatic to the operation of para. 6(2A) that the absolute vesting should be treated as a capital distribution under para. 6(2).

C) Para. 6(2A): the occasion on which a person becomes absolutely entitled to property comprised in a discretionary settlement

Para. 6(2A) provides:

> "Where the whole or any part of the property comprised in a settlement ceases to be comprised in that settlement (otherwise than by virtue of any payment or transfer of assets made by the trustees) at a time when no interest in possession subsists in the property or that part, then, if -
>
> (a) sub-paragraph (2) does not apply; but
> (b) a person at that time becomes entitled to (or immediately thereafter has) an interest in the property or part which would be an interest in possession if held beneficially by an individual,
>
> a capital distribution shall be treated as being made out of the property or that part of the property; and the amount of the distribution shall be taken to be equal to the value at that time of the property or that part of it."

The sub-paragraph was introduced by s. 70, Finance Act 1978 and is designed to prevent the exploitation of the rule under para. 11(10) that certain open companies cannot hold an interest in possession. McCutcheon illustrated the avoidance mechanism at which para. 6(2A) is aimed:

> "Where trustees of a discretionary trust wished to make a distribution payment it was possible to exploit this in the following way. The trustees would appoint the fund absolutely to a beneficiary subject to a contingency and the beneficiary would sell his contingent interest to an open company. At the end of the contingency period the property vested in the company (and therefore ceased to be settled property) without - given the fact that for the purposes of para. 6(2) the company did not become entitled to an interest in possession - any charge to CTT arising. Paragraph 6(2A) prevents this by providing that now there is a notional capital distribution on the company becoming entitled to the property."[1]

1. 9-12.

A capital distribution treated as having been made under para. 6(2A) is treated in the same manner as a capital distribution under para. 6(2). Tax is charged on the distribution by virtue of para. 6(4); para. 11(8) and (5) operate to determine the amount of the deemed distribution payment that enters into the settlement's cumulative total.

As McCutcheon indicated, there would be no need for para. 6(2A) if in the event of a person becoming absolutely entitled to property comprised in a discretionary settlement there was a distribution payment caught by para. 6(1).

He also noted that para. 6(2A)(b) presupposes that an individual who becomes absolutely entitled to settled property becomes entitled to an interest in possession therein; para. 6(2A) would be meaningless were it otherwise. On the principle that 'legislation is presumed to be effective' it must be assumed that on the vesting of settled property absolutely in an individual, he becomes entitled to an interest in possession' an event chargeable by virtue of para. 6(2) and not para. 6(1).

In consequence of the introduction of para 6(2A) it is difficult to conclude otherwise than that the statement of the Inland Revenue as set out above is correct;[1] the case of a beneficiary who becomes absolutely entitled to the property of a discretionary trust is to be equated with the situation where a beneficiary becomes entitled to an interest in possession therein. This causes a notional capital distribution under para. 6(2).

D) Para. 6(3): transactions resulting in the diminution in value of settled property in which no interest in possession subsists

If the value of settled property in which no interest in possession subsists is diminished as a result of a transaction between the trustees and, inter alia, any person for whose benefit the property may be applied, a capital distribution is treated as having been made. The amount of the capital distribution is equal to the amount by which the value of the property is diminished.[2]

1. CTT 1, para. 91, supra, at p. 191.
2. Para. 6(3).

Tax is charged under para. 6(4) as on the value transferred by a chargeable transfer where the value transferred is equal to the amount of the distribution. The grossing up principle in para. 6(4)(a) does not apply.[1] There is a deemed distribution payment under para. 11(8) which, by virtue of para. 11(5), is equal to the value of the capital distribution. The amount of the deemed distribution payment enters into the settlement's cumulative total.

E) Para. 12: the periodic charge

In the words of McCutcheon, periodic charges 'are essentially penal charges - the price under the CTT regime of maintaining a discretionary trust.'[2] It would appear that the charge was incorporated within the scheme of taxation on the principle that 'it would not be right to allow property held in discretionary trusts to remain free of tax for up to a century or more.'[3]

A capital distribution is treated as having been made out of settled property if at a relevant anniversary no interest in possession subsists therein.[4] A relevant anniversary in relation to most settlements occurs at the end of the ten years beginning with the date of making the discretionary settlement and at the end of every subsequent ten years.[5] However, there can be no relevant anniversary before 1st April, 1982.[6]

Tax is charged under para. 6(4) on the amount of the capital distribution; the grossing up principle does not apply.[7] The rate at which tax is charged is 30% of the rate that would have been charged under paras. 6 to 10 on a capital distribution of the same amount made at the same time.[8] However, the rate chargeable under para. 12

1. Para. 6(5).
2. 12-01.
3. Inland Revenue's consultative document, para. 4.2.5.
4. Para. 12(1).
5. Para. 12(6); see Hayton and Tiley, at p. 182.
6. Para. 12(6). Clause 96, Finance Bill proposes that no periodic charge should be made before 1st April, 1983.
7. Para. 6(5).
8. Para. 12(1).

may be reduced if at any time during the ten year period an interest in possession subsisted in the settled property. The rate chargeable in respect of any settled property is reduced by one-tenth for each year throughout which there subsisted an interest in possession. Where the settlor adds property to the settlement after the first year of the ten year period the rate is similarly reduced by one-tenth for each year during which the property was not comprised in the settlement.[1]

A capital distribution treated as having been made under para. 12 is not a deemed distribution payment under para. 11(8), and therefore does not affect the settlement's cumulative total.

In order to prevent a double taxation, para. 13 provides a tax credit system. Thus, the rate of tax charged under para. 12 on a capital distribution which is deemed to have been made on the relevant anniversary is taken to reduce the rate of tax that would be charged on any subsequent capital distribution made up to twenty years after the relevant anniversary.[2] The credit is not allowed against future periodic charges under para 12.[3]

By virtue of para. 13(2) a tax credit cannot be used twice; it is available to reduce the amount of tax charged on a capital distribution, but once used, further capital distributions are charged in the normal way without any reduction.[4]

The credit takes effect by reducing the rate of tax chargeable on any subsequent capital distribution. It does not therefore affect the amount of the deemed distribution payment which enters the settlement's cumulative total under para. 11(8) and (5).

1. Para. 12(4).
2. See Foster, C4.03.
3. Para. 13(1).
4. Dymond, at p. 731.

In respect of settlements the trustees of which are not resident in the United Kingdom, a similar periodic charge is made at the end of each year of the ten year period if no interest in possession subsists in the settled property at that time.[1] The rate at which tax is charged is 3% of the rate that would have been charged under paras. 6 to 10 had a capital distribution of the same amount been made at the same time. A tax credit system operates similar to that available in the case of settlements the trustees of which are resident in the United Kingdom.[2]

F) Para. 15(3): the occasion on which the conditions of para. 15(1) become satisfied

Para. 15 relates to accumulation and maintenance trusts. Where the conditions specified in para. 15(1) are satisfied the settlement is exempt from various charges to tax under paras. 6 to 12.[3]

Where no interest in possession subsists in the settled property, a capital distribution is treated as having been made on the occasion that the conditions specified in para. 15(1)(a) and (b) become satisfied.[4]

The amount of the distribution is taken to be the value of the property in respect of which the conditions become satisfied.[5]

Tax is charged under para. 6(4)(a) on the value transferred by a chargeable transfer where the value transferred is equal to an amount which net of tax is equal to the value of the capital distribution. The grossing up principle does not apply if the tax is paid out of the property the value of which is taken as the amount of the capital distribution.[6]

1. Para. 12(2).
2. Para. 12(3).
3. Infra, at p. 205.
4. Para. 15(3). See Inglewood v. I.R.C., [1981] S.T.C. 318.
5. Para. 15(3).
6. Para. 6(5).

There is a deemed distribution payment under para. 11(8) equal to the amount on which tax is charged.[1] This amount enters into the settlement's cumulative total.

G) The alteration of shares in a close company

Under s. 118, Finance Act 1976 a capital distribution may be treated as having been made on the alteration of, inter alia, the shares of a close company of which a trustee of the settlement is a participator.

Rates at which tax is chargeable under the discretionary settlement regime

Under the discretionary settlement regime the rate at which tax is chargeable in the event of a capital distribution is determined by reference to the second table set out in s. 37(3),[2] viz, the table applicable to lifetime transfers.

The rate at which tax is charged on the capital distributions of settlements made inter vivos after 26th March, 1974, or on a death after 12th March, 1975 is usually determined according to the rules of para. 7:[3] the rate depends to a certain extent upon the personal rate of tax of the settlor when he constituted the settlement.

For the purpose of computing the rate under para. 7 the life of the settlement is in two consecutive phases.[4]

The settlement is in phase 1 when the amount on which tax is to be charged when added to any previous distribution payments does not exceed the value of the settled property when it first became comprised in the settlement (the initial value). The rate applicable in phase 1 is $\frac{X}{Y}$ where -

1. Para. 11(5).
2. Para. 6(4).
3. Dymond, at p. 685-686.
4. Ibid., at p. 685-691.

X is the amount of tax which would have been charged had the settlor on constituting the settlement made a gross transfer equal to the initial value of the settled property; and
Y is the initial value of the settled property.

While the settlement is in phase 1 the rate at which tax is chargeable will be constant.

The settlement is in phase 2 when the amount on which tax is to be charged when added to any previous distribution payments exceeds the initial value of the settled property. The rate applicable is that of a person who had made previous chargeable transfers and the value transferred by them was equal to the aggregate of -

a) the values transferred by any chargeable transfers made by the settlor before he constituted the settlement;
b) the initial value of the settled property; and
c) the amounts of any previous distribution payments which have been made since the settlement entered into phase 2 of its existence.

Once the settlement is in phase 2 the rate will increase as further distribution payments are made.

The rates at which tax is charged on capital distributions in respect of settlements to which para. 8 applies are computed without reference to the personal circumstances of the settlor. Para. 8 applies to settlements other than those to which para. 7 applies.

The amount on which tax is chargeable under para 8 is charged at the rate of a person who had made previous chargeable transfers equal to the amount of the distribution payments made out of the settled property since 26th March, 1974, but who had otherwise made no chargeable transfers. The settlement has its own independent cumulative total.

THE MEANING OF 'INTEREST IN POSSESSION'

From the foregoing discussion it will be apparent that the treatment of settled property in which there subsists an interest in possession radically differs from the system of taxation of settled property in which no such interest subsists.

The capital transfer tax legislation provides little guidance as to the meaning of the expression 'interest in possession', although in relation to Scotland Para. 1(9) provides:

> " ... any reference to an interest in possession in settled property is a reference to an interest of any kind under a settlement by virtue of which the person in right of that interest is entitled to the enjoyment of the property or would be so entitled if the property were capable of enjoyment including an interest of an assignee under an assignation of an interest of any kind (other than a reversionary interest) in property subject to a proper liferent and the person in right of such an interest at any time shall be deemed to be entitled to a corresponding interest in the whole or any part of the property comprised in the settlement."

Para. 11(10), which relates to both Scotland and England, provides that 'interest in possession' means an interest in possession to which an individual is beneficially entitled.[1] Thus, trustees of a settlement are incapable of holding an 'interest in possession' in the settled property of another settlement: trustees are neither 'individuals' nor would their interest be of a beneficial nature.

Clearly, para. 11(10) is of no assistance in determining what an 'interest in possession' is; therefore, for the purpose of its application in England the phrase is not defined.

Traditionally, an interest is 'in possession when it is not 'in reversion' or 'in expectancy':[2] but, as Walker queried:

1. A company is entitled to an interest in possession only if it satisfies the conditions set out in para. 11(10)(a) and (b), and para. 11(10A).
2. Stroud's Judicial Dictionary, 4th ed., vol 4, at p. 2059.

" ... does it extend to an interest which is revocable; to an interest which is subject to a power of accumulation, or a power to divert to another beneficiary or class of beneficiaries; or (in any circumstances) to an infant's interest?"[1]

The decision of the House of Lords in Pearson v. I.R.C.[2] has to a certain extent removed some of the doubts surrounding the meaning of the phrase. However, prior to the Pearson case there were certain established principles. Thus, the discretionary object of a discretionary settlement to whom no income or property had been appointed was considered not to have had an interest in possession: this is the principle in Gartside v. I.R.C.:

"'In possession' must mean that your interest enables you to claim now whatever may be the subject of the interest. For instance, if it is the current income from a certain fund your claim may yield nothing if there is no income, but your claim is a valid claim, and if there is any income you are entitled to get it. But a right to require trustees to consider whether they will pay you something does not enable you to claim anything. If the trustees do decide to pay you something, you do not get it by reason of having the right to have your case considered; you get it only because the trustees have decided to give it to you."[3]

It was also recognised that a trust to accumulate has the effect of negating an interest in possession. On the basis of Attorney-General v. Power,[4] Wylie noted:

" ... it was always reasonably clear that a trust to accumulate income precluded there from being an interest in possession in settled property during the accumulation period if there was a possibility that the beneficiary might not ultimately become entitled to the accumulations. This was so even if the trustees had power to pay maintenance during the accumulation period."[5]

1. "The Meaning of 'Interest in Possession' in the Finance Act 1975": /_1976_/ B.T.R. 49, at p. 49.
2. /_1980_/ S.T.C. 318.
3. /_1968_/ A.C. 553, at p. 607 per Lord Reid).
4. /_1906_/ 2 I.R. 272.
5. "Capital Transfer Tax - Interests in Possession": (1980) 106 Taxation 307, at p. 309.

The principles in the Gartside and Power cases were not readily applicable to the facts in Pearson v. I.R.C. The facts in Pearson's case may be stated quite shortly.

The trustees of a trust constituted in 1964 held shares in P.B. Ltd. They were empowered to appoint both the capital and income to various discretionary objects. However, in default of and until such appointment the trustees were given the power to accumulate the income as they saw fit for a period of twenty-one years, and subject to that power they were to hold both capital and income for such of the "Principal Beneficiaries" who should attain twenty-one years.

By 1974 all the Principal Benficiaries had attained the age of twenty-one. The trustees had accumulated the income since 1964, but in 1976 a life interest in £16,000 was appointed to one of the Principal Beneficiaries. This would have been a chargeable event by virtue of para. 6(2) if no interest in possession in the settled property subsisted prior to the appointment.

Fox, J. and the judges of the Court of Appeal distinguished the case from Gartside v. I.R.C. and Attorney-General v. Power. The distinction drawn was that in those cases 'the beneficiaries got nothing unless the trustees decided to give it to them' whereas in the present case the [Principal Beneficiaries] were absolutely entitled unless the trustees decided to accumulate"[1] They held that the right of each beneficiary was an interest in possession; it was a present right as opposed to a future right in remainder or in reversion. In consequence, there could be no charge by virtue of para. 6(2) on the appointment of the life interest in 1976. It was generally thought that the existence of a mere power to accumulate could not negate an interest in possession.[2]

1. This summary of the distinction drawn at first instance and in the Court of Appeal was presented by Viscount Dilhorne, [1980] S.T.C. 318, at p. 325.
2. Cf. the trust to accumulate in Attorney-General v. Power. The distinction between a 'trust' and a 'power' was discussed in McPhail v. Doulton, [1970] 2 All E.R. 228.

The majority in the House of Lords took the opposite view. They held that an interest in possession is 'a present right of present enjoyment', and that prior to the appointment in 1976 none of the beneficiaries had such a right.

Viscount Dilhorne was of the opinion that the Principal Beneficiaries entitlement depended upon whether or not the power to accumulate the income was exercised. While the trustees exercised the power the beneficiaries could have no interest in possession; they were entitled to nothing. However, he conceded that had the beneficiaries been entitled to the income, then the mere presence of an overriding power of appointment or revocation would not have affected their interests as being interests in possession.[1]

Lord Keith drew attention to para. 3(2) and (3) which provide that an entitlement to part of the income of the settlement is treated as an interest in possession in a proportionate part of the property.[2] He suggested that those sub-paragraphs operate only in respect of an absolute entitlement to part of the income and not to an entitlement qualified by a power of accumulation. He argued that this principle is equally applicable where the beneficiary's interest extends to the whole of the income; the inference being that an entitlement to the entire income qualified by a power of accumulation cannot be considered as an interest in possession in the entire property.[3]

As to the distinction drawn in the courts below between the position of a discretionary object and the position of a beneficiary who will take unless the trustees appoint elsewhere, Lord Keith stated:

1. [1980] S.T.C. 318, at p. 325.
2. Supra. at p. 182.
3. Ibid., at p. 334.

" ... I do not consider it to be a satisfactory state of affairs that the question whether a person has an interest in possession should turn on the distinction between the position where his interest derives from his being the object of a discretionary power and that where his interest results in a benefit only failing the exercise of such a power. The practical results as regards the person having the interest are unlikely to be materially different in either case, and I can see no good reason why the distinction should lead to a difference of treatment for purposes of capital transfer tax. The distinction between a trust and a power may be of importance for certain other purposes ... but none of the considerations leading to that result appear to me to be applicable here."[1]

Thus it would appear that a beneficiary has an interest in possession if he is entitled indefeasibly to the intermediate income as it arises from the settled property. The existence of a power to prevent the beneficiary's receipt of income arising in future does not affect his present right of enjoyment as an interest in possession. However, a power to divert the intermediate income from the beneficiary after it has arisen has the effect of negating an interest in possession.

Somewhat surprisingly the Law Lords did not think it incumbent on them to consider the interpretation of the expression 'interest in possession' as it applies in Scotland. Viscount Dilhorne thought that there was no 'justification for concluding that a provision inserted for the purpose of applying Sch 5 to Scotland defines the meaning of those words in the Schedule in their application to England and Wales.'[2]

It would appear that the definition of an interest in possession in settled property was provided for Scotland for the reason that the nature of the interest under a Scottish trust differs from that under an English trust:

1. Ibid., at p. 334-335.
2. [1980] S.T.C. 318, at p. 323.

"The suggestion has been made that the provision of a separate definition for Scotland is based on the Scottish principle that a life tenant does not have any right of ownership in the property concurrent with the trustees' right, but is only entitled to the income of the property as it arises. In England a life tenant is treated as having a right of ownership of the property different from but concurrent with that of the trustees. In ordinary language it is difficult to comprehend the argument that a person beneficially entitled to the income as it arises from property does not have a beneficial interest in the property producing the income whatever the technicality of ownership. However, if this is not the view of the Revenue, presumably some separate meaning for Scotland will remain."[1]

This tends to support the argument raised in Part 1 that if Baker v. Archer[2] is considered to be a decision based upon pure trust law, then the principle in the case has no application in Scotland.[3] It was stressed in I.R.C. v. Clark's Trs.[4] that the beneficiary of a Scottish trust has no interest in the trust property; his interest is essentially a jus crediti to enforce the administration of the trust.

If the suggestion in Foster is correct, it is strange that an equivalent definition of 'interest in possession in settled property' in relation to Scotland was not provided in the capital gains tax legislation. It will be recalled that there is a deemed disposal of settled property by the trustees on the occasion of the termination of a life interest in possession therein.[5] It can only be assumed that for the purposes of capital gains tax, in accordance with the decision in Pearson's case, a life interest is in possession when the tenant for life has a present right of present enjoyment of the settled property or the income therefrom.

1. Foster, C1.04, at C114; also Dymond, at p. 571-572.
2. (1927) 11 T.C. 749.
3. Supra, at p. 26 - 29.
4. 1939 S.C. 11.
5. S 55, Capital Gains Tax Act 1979; supra, at p. 162.

What is not clear in the light of the Pearson decision is the consequence of the trustees accumulating in one year and not in the next and so on.[1] The consequence is of significance in respect of both capital gains tax and transfer tax. Perhaps the problem will be resolved by the legislature in the overhaul of the capital transfer tax charging code for settlements promised by the Chancellor in his 1981 budget speech. However, the issue was not raised in the Inland Revenue's consultative document.

THE FAVOURED TRUSTS

Certain types of settlement are granted an exemption from the operation of the various charging provisions noted above. Of particular interest in relation to this discussion are those exemptions in favour of accumulation and maintenance trusts, and protective trusts.

Accumulation and Maintenance Trusts

Where the conditions specified in para. 15(1) are satisfied, an accumulation and maintenance settlement is exempted from several of the charges to capital transfer tax.[2] Thus, the payment of a capital sum to a beneficiary of a qualifying accumulation and maintenance trust will not constitute a capital distribution under para. 6(1);[3] neither will a capital distribution be treated as having been made under para. 6(2) on the occasion of a beneficiary becoming entitled to an interest in possession in any of the property. Further, during the process of accumulation the settlement cannot be subjected to a periodic charge under para. 12.

In order that the settlement qualifies for the exemptions under para. 15(2) it must comply with the stringent conditions set out in para. 15(1). Para. 15(1) provides:

1. Thompson, (1981) 97 L.Q.R. 1.
2. Para. 15(2).
3. It will, however, constitute a distribution payment which will affect the settlement's cumulative total: see Foster, C5.01, at C233.2.

"This paragraph applies to any settlement where -

(a) one or more persons (in this paragraph referred to as beneficiaries) will, on or before attaining a specified age not exceeding twenty-five, become entitled to, or to an interest in possession in, the settled property or a part of it; and
(b) no interest in possession subsists in the settled property or part and the income from it is to be accumulated so far as not applied for the maintenance, education or benefit of a beneficiary; and
(c) either -
(i) not more than twenty-five years have elapsed since the day on which the settlement was made or, if it was later, since the time (or latest time) when the conditions stated in paragraphs (a) and (b) above became satisfied with respect to the property or part; or
(ii) all the persons who are or have been beneficiaries are or were either grandchildren of a common grandparent or children,[1] widows or widowers of such grandchildren who were themselves beneficiaries but died before the time when, had they survived, they would have become entitled as mentioned in paragraph (a) above."

The condition in para 15(1)(a) will be satisfied where, although no age of vesting is specified in the settlement, it may be ascertained that at the time of vesting the beneficiary will be below the age of twenty-five. The Inland Revenue take the view that the condition will be satisfied if 'it is clear that a beneficiary will in fact become entitled to the settled property (or to an interest in possession in it) by the age of 25.'[2]

It is imperative that one or more persons before attaining the age of twenty-five will become entitled to an interest in possession. 'Will' does not mean 'might'. In Dymond it is noted:

1. A person's children include his illegitimate children, adopted children and step-children - para. 15(6).
2. [1977] B.T.R. 947. This ignores the proposition of Rowlatt, J. in White v. Whitcher, that 'attaining a specified age' means 'living to a point of time defined by reference to the then age of the person - not to a point of time fixed by other occurrences, although, of course, when the data is ascertained, it will be known how old everyone in the world, including any given person, will be'; (1927) 13 T.C. 202, at p. 205.

> "It does not suffice that, as things stand at a particular moment, he would become entitled if nothing (apart from his own death) should occur to disentitle him (either permanently or till after the specified age); the analogy is with an heir apparent, who will become entitled if he survives, in contrast to an heir presumptive, who may or may not become entitled even though he survives."[1]

It would appear that certain events which might operate to defeat the vesting are to be ignored. By concession, the Inland Revenue do not treat a settlement as failing to satisfy condition (a) merely by reason of the existence of a power of advancement.[2] However, in Inglewood v. I.R.C.[3] it was held that the existence of a power to revoke an appointment of an interest due to vest on the beneficiary attaining a specified age below the age of twenty-five years was such that the settlement failed to satisfy condition (a); but Vinelott, J. was of the opinion that the condition is satisfied despite the fact that the beneficiary may be deprived of his interest on the happening of some event not specified in the settlement.

The condition in para. 15(1)(b) is satisfied only where there is a 'trust' to accumulate; it is not satisfied where there is the mere power of accumulation. Thus where the terms of the trust specify an accumulation period, during that period the condition is satisfied. If, after the period the trustees are directed to appoint the income to A and B, but have an overriding power of accumulation exercisable at their discretion, then after the prescribed accumulation period condition (b) ceases to be satisfied whether or not the trustees in fact continue to accumulate the income.[4]

1. At p. 740.
2. [1975] B.T.R. 437.
3. [1981] S.T.C. 318.
4. See Hayton and Tiley, at p. 202-203.

The condition in para. 15(1)(c) comprises two alternatives one of which must be satisfied. The condition was introduced by the Finance Act 1976 to counteract 'the possible creation of trusts for the benefit of successive generations of beneficiaries who would qualify for the relief, which was not intended."[1]

'Persons' in para. 15 include unborn persons, although conditions (a) and (b) will not be considered as satisfied unless there is or has been at least one living beneficiary.[2]

Protective Trusts

Para. 18 affords a limited protection from capital transfer tax in respect of 'settled property held on trust to the like effect as those specified in section 33(1) of the Trustee Act 1925.' Para. 18(2) provides:

> "For the purposes of capital transfer tax -
>
> (a) there shall be disregarded the failure or determination, before the end of the trust period, of trusts to the like effect as those specified in paragraph (i) of the said section 33(1); and
> (b) the principal beneficiary shall be treated as beneficially entitled to an interest in possession in any property which is for the time being held on trusts to the like effect as those specified in paragraph (ii) of the said section 33(1)."[3]

Thus, there is no charge to tax under para. 4(2) on the occasion that the principal beneficiary's interest comes to an end during the trust period.

The discretionary trust which in fact arises under s. 33(1)(ii), Trustee Act 1925 is to be treated for the purposes of capital transfer tax as if an interest in possession subsists in the settled property; the principal beneficiary is treated as being entitled to that interest. The discretionary trust is, therefore, exempt

1. Dymond, at p. 739.
2. Para. 15(5).
3. "Principal beneficiary" and "trust period" have the same meaning as in s. 33, Trustee Act 1925.

from any periodic charge under para. 12. A payment of capital to the principal beneficiary will not attract a charge to tax; however, a capital payment of trust property to others will be treated as the termination of the principal beneficiary's interest in that property and will attract a charge to tax under para. 4(2).

Para. 18(2)(b) applies to property which is 'for the time being' held on trusts to the like effect as those in s. 33(1)(ii), Trustee Act 1925. S. 33(1)(ii) applies during the residue of the trust period only. It would appear that at the end of the trust period tax will be charged as if the principal beneficiary's interest had terminated; thereafter, the property enters into the discretionary settlement regime.

It is not clear when property will be held on trusts 'to the like effect' as those specified in the Trustee Act, s. 33(1).[1] The Inland Revenue take the view that such trusts must not be materially different to s. 33(1) trusts in respect of their tax consequences. They are not to be distinguished by reason of minor variations or additional administrative powers; however, 'the extension of the list of potential beneficiaries to brothers and sisters of the principal beneficiary could be a means of giving relief to a trust primarily intended to benefit them. Such a trust would be regarded as outside the scope of paragraph 18.'[2]

The concept of the protective trust is useful to a settlor who wishes the beneficial interest under a trust to be enjoyed by the beneficiary alone and not by that beneficiary's creditors or assignees. The beneficiary's interest lapses on his becoming bankrupt or on the occasion of an attempted assignation. It is impossible in England to protect the beneficial interest for the enjoyment of a particular beneficiary: the safeguard afforded by

1. See Thomas v. I.R.C., [1981] S.T.C. 382, a case which arose prior to the Finance Act 1978. The Finance Act 1978 substantially amended the original para. 18.
2. 1979 Simon's Tax Intelligence, at p. 282.

a protective trust is for the beneficial interest in the property itself and not for the beneficiary; the beneficiary under a protective trust loses his interest in the event of an attempted assignation or bankruptcy.[1]

The position in Scotland is different. A liferent may be protected by being declared alimentary. The alimentary liferenter cannot assign his interest, nor can it be subject to the diligence of his creditors.[2] The difference between the English protective trust and the Scottish alimentary liferent is that in the event of an attempted assignation or bankruptcy the alimentary liferenter's interest does not lapse but remains for his enjoyment.[3]

However, the amount which may be protected by means of an alimentary liferent must not be excessive in relation to the position and circumstances of the liferenter. It would appear that the excess which is not required for the maintenance of the liferenter is assignable and may be subject to the diligence of creditors.[4] Thus, a truster who wishes to protect a particularly valuable liferent should consider the creation of a trust to the like effect as those specified in s. 33(1), Trustee Act 1925; a trust which will enjoy the exemptions from capital transfer tax provided by para. 18.

CONCLUSION

The main capital transfer tax chargeable events which affect a settlement of capital have been outlined above.

1. Snell's Principles of Equity, 27th ed., at p. 135-136.
2. Dobie, "The Manual of the Law of Liferent and Fee in Scotland", at p. 231.
3. Ibid., at p. 235.
4. Ibid., at p. 233-234.

To establish an income tax effective settlement of capital the settlor exposes himself to a charge to capital transfer tax on constituting the trust. If there is no interest in possession in the settled property, while the income accumulates the capital will be subject to the periodic charge. Any payment of capital from a discretionary and accumulation trust will attract a charge to capital transfer tax. The occasion on which a person becomes entitled to an interest in possession in the settled property is a chargeable event, so too is the event of a person becoming absolutely entitled to the property itself.

The value of the estate of a person who is entitled to an interest in possession in settled property is made artificially high. Capital transfer tax is chargeable on the death of the beneficiary and on the termination of the interest during his life or on the occasion that the beneficiary disposes of his interest.

The capital transfer tax consequences of an income tax effective settlement of capital are formidable. However, a considerable relief is provided by para. 15. By virtue of para. 15, it is possible to accumulate income for a period of up to twenty-five years without suffering unduly the severe effects of capital transfer tax. The potential beneficiary of a favoured accumulation and maintenance trust must be below the age of twenty-five which is regrettable bearing in mind the object of the accumulation. An accumulation trust is income tax effective only if the beneficiary to whom the capitalized income will be paid has a personal rate of tax in excess of 45%. Few persons below the age of twenty-five will possess such a high income; para. 15 is not, therefore, quite such a generous provision as it might appear.

S U M M A R Y

Apart from Part XVI, I.C.T.A. (which, in essence, is an assemblage of anti-avoidance provisions rather than an organised structure of taxation) the income tax legislation provides no separate code expressly for the purposes of trust taxation. In consequence, any theory as to the liability to tax or otherwise of either the trustee or beneficiary must accord with the existing schedular system. Thus, in general, trustees and beneficiaries are assessable to tax on the basis that they are persons who receive or are entitled to receive income from a source designated in the Schedules.

The general theory is not applied strictly in so far as the taxation of the trustee is concerned. It has been noted that a trustee who is resident in the United Kingdom may not be assessed to tax on the income which he receives from a foreign source and which is payable to known foreign beneficiaries. In such a case the trustee is recognised as acting in a representative capacity on behalf of the foreign beneficiaries, and on this basis he may have a good answer to a particular assessment to tax.

Where both the trustee and beneficiary are resident in the United Kingdom the trustee will be chargeable to tax in respect of the trust income. It is of no consequence that the beneficiary to whom the income eventually will be paid has unused personal allowances and so will not be liable to tax on the trust income which he receives. It would appear that the trustee will be recognised as acting in a representative capacity only where the trust income is paid to a beneficiary who is not assessable to tax by reason of his residing outwith the United Kingdom.

The problems associated with the taxation of the beneficiary are more complex.

It has been explained that, in the light of the decision in Garland v. Archer-Shee[1], it is the technical nature of the beneficiary's

1. (1931) 15 T.C. 693.

interest under a trust that determines the Schedule by virtue of which he may be assessed to tax. It has also been explained that, prior to the decision of the House of Lords in Baker v. Archer-Shee,[1] the beneficiary's interest under a Scottish or English trust was considered to be in the nature of a jus in personam, to compel due administration of the trust.

The beneficiary's interest as a jus in personam would entitle him to income from the trust but not to the income of the trust. He would be entitled to whatever income remained after the completion of the trust administration. In effect, the trust itself would be the source of the beneficiary's income: the actual source of the trusts income would not affect the Schedule under which he could be assessed to tax.

However, from the decision in Baker v. Archer-Shee it must be inferred that a beneficiary who is entitled to have paid to him income arising under an English trust must be assessed to tax under the Schedule appropriate to the source of the trust's income.

The decision in Baker v. Archer-Shee is inconsistent with the theory that the nature of a beneficiary's interest is a mere right to compel administration of the trust. If the decision is considered to be based upon a finding of trust law, the case has no application in Scotland. In I.R.C. v. Clark's Trs.[2] the Court of Session firmly rejected the notion that the nature of a beneficiary's interest under a Scottish trust could be anything other than a jus crediti, to enforce the administration by the trustees.

Thus, if Baker v. Archer-Shee is not accepted as binding upon the Scottish courts, the beneficiary of a Scottish trust must be considered as being entitled to income from the trust, whereas the beneficiary of an English trust must be assessed to tax on the basis

1. (1927 11 T.C. 749.
2. 1939 S.C. 11.

that he is entitled to the income of the trust. The two beneficiaries in substance might be in the same position and yet may be assessed to tax under differing Schedules.

It is suggested that a possible solution to the problem is to construe Baker v. Archer-Shee as a decision based upon pure income tax law divorced from considerations of the law of trusts. Hence, as a principle of tax law, for income tax purposes the beneficiary of a trust constituted and domiciled anywhere in the United Kingdom is treated as being entitled to the income of the trust: he is not merely entitled to compel administration of the trust. Because of the decision in Garland v. Archer-Shee, it is not possible to extend the principle to determine the nature of the beneficiary's interest under trusts constituted and domiciled outwith the United Kingdom.

As a rule of pure tax law, the principle of the decision in Baker v. Archer-Shee would be applicable in Scotland as it is in England. The beneficiary under a Scottish or English trust would be assessed to tax under the Schedule appropriate to the source of income of the trust.

Assuming that there is a Schedule appropriate to the source of the trust's income, the beneficiary may be assessed to tax only on so much of the income to which he is entitled. The amount of income to which he is entitled will usually depend upon the construction of the trust instrument.

The taxation of discretionary and accumulation trusts is complicated by ss.16 and 17, Finance Act 1973.

The trustee of a discretionary or accumulation trust may be assessed to tax at the additional rate on the trust income to which s. 16 applies. S. 16 does not apply to trust income if it is treated as the income of the truster for any purpose of the Income Tax Acts, or if, while in the hands of the trustees, it forms the income of any person other than the trustees.

Thus, income capitalized in the hands of the trustees is not chargeable to tax at the additional rate if it is accumulated on behalf of a beneficiary who is sui juris and who has the power to terminate the trust. Neither does s. 16 apply to income which remains in the hands of the trustees but in which a person has a vested interest.

S. 17 provides the machinery for the taxation of payments from a discretionary trust. The machinery of s. 17 supplies the means by which the tax paid by the trustees at the additional rate under s. 16 may be recovered.

In order that the payment qualifies for treatment under s. 17 it must be paid in exercise of a discretion and must form the income of the person to whom it is paid. Further, the payment must satisfy the conditions precedent to chargeability under Schedule D Case III; it must be paid under an obligation and must be capable of recurrence.

It has been noted that a payment from the capital of a trust pursuant to the exercise of an absolute discretion is considered to fulfil the conditions of chargeability under Schedule D Case III. This begs the question: 'when will a payment from capital at the exercise of an absolute discretion constitute a capital receipt in the hands of a beneficiary?'

If the fiscal benefits of an accumulation trust are to be enjoyed, the truster must effectively alienate his income. By virtue of the provisions of Part XVI, I.C.T.A., alienation of income is, in general, an arduous method of saving tax.

The operation of the provisions of Part XVI in relation to the trust concept has been demonstrated. Depending upon the circumstances of the case, income arising under a trust may be treated for tax purposes as the income of the truster. However, the income arising under a trust which is a mere part of a 'settlement' may be attributed to a 'settlor' other than the truster. Thus it is possible that neither the truster, trustee nor beneficiary may be assessable to tax in respect of the trust income.

The effect and interrelation of the provisions of Part XVI is considered in Part 2 of this work: it is noted that a trust constituted for the purpose of avoiding tax at the higher rates must comprise capital of which the truster has divested himself absolutely.

A settlement of capital may be subject to both capital gains and transfer tax. An outline of the capital tax treatment of the trust is provided in Part 3. The capital tax consequences of a settlement of capital are briefly summarized below, although the variations on the theme are infinite.

In order to create a settlement of capital the truster exposes himself to a charge to capital gains and transfer tax. An accumulation trust might provide an effective tax shelter, but it attracts the periodic charge to capital transfer tax. However, the periodic charge will not apply if the trust is protected under para. 15 of Schedule 5 to the Finance Act 1975.

The granting of an interest in possession is an event which may occasion a charge to capital transfer tax. A charge may also arise on the termination of the interest, and, if the interest was a life interest in possession, there may be a charge to capital gains tax. However, there can be no charge to capital gains tax if the life interest in possession terminates by reason of the death of the tenant for life.

Capital gains tax may be charged on the occasion that a person becomes absolutely entitled to the property of the trust. There will also be a charge to capital transfer tax unless the person who becomes absolutely entitled to the property previously held an interest in possession therein.

Obviously, when account is taken of the capital taxes, the income tax advantages of a settlement of capital appear less attractive; the income taxation of trusts, in practice, cannot be considered in isolation.

APPENDICES

APPENDIX 1. AN OUTLINE OF THE CONCEPT OF 'TRUST'

The trust is an elusive character; like other legal concepts, it cannot be satisfactorily defined. As Scott suggested:

> "All that one can properly attempt to do is to give such a description of a legal concept that others will know in a general way what one is talking about."[1]

The concept is characterised by certain established principles. It is doubted that any English lawyer would suggest that the principles recited by Bell are not equally applicable to the concept of the trust in England.

> "The whole doctrine and practice depends on these principles -
>
> 1. That a full legal estate is created in the person of the trustee, to be held by him against all adverse parties and interests, for the accomplishment of certain ends and purposes.
> 2. That the uses and purposes of the trust operate as qualifications of the estate in the trustee, and as burdens on it preferable to all who may claim through him.
> 3. That those purposes and uses are effectually declared by directions in the deed, or by a reservation of power to declare in the future, and a declaration made accordingly.
> 4. And that the reversionary right, so far as the estate is not exhausted by the uses and purposes, remains with the truster, available to him, his heirs and creditors."[2]

In Wilson and Duncan it is suggested that the first two of these principles are features of a trust but the other two are not applicable to all examples of the trust relationship.[3] Thus the third principle will not apply to trusts which arise by operation of law, and in relation to charitable trusts the cy-près doctrine operates as an exception to the fourth principle.

1. Trusts, 3rd ed., para. 2.
2. Principles of the Law of Scotland, at s. 1991.
3. At p. 17.

Underhill defined an English trust as "an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called beneficiaries or cestuis que trust), of whom he may himself be one, and any one of whom may enforce the obligation."[1]

A popular Scottish definition reads;

> "The contract [of trust] may perhaps be explained as one in which the legal title to property is transferred to a person called a trustee, who does not acquire an unlimited right to the property, but who holds it subject to an obligation to use it in accordance with the directions, express or implied, of the person who constituted the trust, for the benefit of certain persons of whom he may or may not himself be one."[2]

It is immediately noticeable that, conceptually, there is little difference between the English and Scottish trust. Wilson and Duncan have indicated that the definitions propounded by English writers are of little assistance when defining the trust in Scotland but this is so merely because most English definitions include the word 'equitable'.[3]

It is interesting to note that despite their similarity the Scottish and English trust originate from remarkably diverse backgrounds.

It would appear that the Scottish trust has its roots in the contracts of mandate and depositum. The Lord President in Croskery v. Gilmour's Trs. observed:

> "A trust is a contract made up of the two nominate contracts of deposit and mandate. The trust funds are deposited for safe custody, and the trustees receive a mandate for their administration."[4]

1. Underhill's Law of Trusts, 13th ed., at p. 1.
2. The Enclyclopaedia of the Laws of Scotland, Vol. 15, para. 362.
3. At p. 17.
4. (1890) 17 R. 697, at p. 700.

Of mandate, Stair stated:

> "The requisites of this contract must be first, a desire, warrant, or order, upon the part of the mandant to the mandantar, to do some affair, to the behoof of the mandant only; ... or to the behoof of a third party only ..."[1]

> "The obligation arising from mandates is chiefly upon the part of the mandantar, to perform his undertaking, wherein he is obliged to follow the tenor of his commission, in forma specifica, in so far as it is special and express, ..."[2]

Depositum, according to Stair, 'is most fitly expressed by the duty and obligation thereof, which is "to keep and preserve that which is given in custody," and it is here subjoined to mandate, because indeed it is a kind of it.'[3] However:

> "... depositum also may be fitly defined, to be "a mandate or commission, given and undertaken, to keep and preserve something belonging to the mandantar or some third party;" and therefore, whatever hath been before said of mandates, must be here understood of custody, and needs not be repeated, except what is special in custody."[4]

Stair further provided that:

> "Trust is also a kind of depositation, whereby the thing intrusted is in the custody of the person intrusted, to the behoof of the intruster, and the property of the thing intrusted, be it in land or moveables, is in the person of the intrusted, else it is not proper trust: ... "[5]

This proposition is supported by Erskine who stated:

> "A trust is also of the nature of deposition, by which a proprietor transfers to another the property of the subject intrusted, not that it should remain with him, but that it may be applied to certain uses for the behoof of a third party."[6]

1. "Institution of the Law Scotland", at I, 12, 1.
2. Ibid., at I, 12, 9.
3. Ibid., at I, 13, 1.
4. Ibid., at I, 13, 1.
5. Ibid., at I, 13, 7.
6. "An Institute of the Law of Scotland", at III, 1, 32.

Thus, the trust is a kind of depositation, and depositum may be fitly defined as a mandate or commission. The position is somewhat confused although Stair also recognised that 'trust is also among mandates or commissions, though it may be referred to as deposition.'[1]

The origins of the trust in England differ greatly from those of its Scottish counterpart. The English trust is essentially the product of the Chancery. No rights of the beneficiary were recognised at common law; the position is neatly illustrated by the example provided by Hanbury and Maudsley:

> "If land is given to A on A's undertaking to hold the land to the use and benefit of B, it is unconscionable for A to keep it for his own benefit. B however has no legal claim or title to the land. The conveyance to A gives him whatever legal estate was conveyed, and at common law, A can exercise all the rights which that estate gives to him.
>
> "The Chancellor [i.e., equity] interfered to compel A to hold the land for the exclusive use and benefit of B. The Chancellor cannot say that B is the owner; A is. But all the beneficial interest in the land can be given to B by compelling A to keep the legal title only, and to give all the benfit of the land to B. This is what happens when the use is enforced."[2]

The existence of a contract between the settlor and the trustee is not essential to the creation of a valid trust. However, where there is an enforceable contract between the settlor and his trustee there is no reason why the settlor could not maintain an action for breach of contract should the trustee act in breach of trust, provided that the act which constitutes the breach of trust amounts to a breach of contract.[3] By reason of the doctrine of privity of contract such a course of action would not be open to the beneficiary of an English trust despite the fact that the terms of the contract operate in his favour. Viscount Haldane stated the position in England thus:

1. "Institution of the Law of Scotland", at I, 12, 17.
2. Modern Equity, 10th ed., at p. 7. The 'use' is the forerunner of the modern trust.
3. Snell's Principles of Equity, 27th ed., at p. 90.

" ... in the law of England certain principles are fundamental. One is that only a person who is party to a contract can sue on it. Our law knows nothing of a jus quaesitum tertio arising by way of contract. Such a right may be conferred by way of property, as, for example, under a trust, but it cannot be conferred on a stranger to a contract as a right to enforce the contract in personam."[1]

In Scotland it is a long established rule that in certain circumstances a person may sue on a contract to which he was not a party where that person has a jus quaesitum for its enforcement. Stair provided:

"... when parties contract, if there be any article in favour of a third part, at any time, est jus quaesitum tertio, which cannot be recalled by either or both of the contractors, but he may compel either of them to exhibit the contract, and thereupon the obliged may be compelled to perform."[2]

It is essential that the jus quaesitum is irrevocable for it 'is obvious that if A and B contract and nothing else follows, and no one is informed of the contract, A and B can agree to cancel the contract.[3] Lord Dunedin in Carmichael v. Carmichael's Exrs. listed the events which may lead to irrevocability. These were succinctly summarised by Walker who stated that irrevocability

" ... is established by the delivery of the contractual document to the tertius, by registration for publication in the Books of Council and Session, by intimation to the tertius, by the tertius coming under onerous undertakings on the faith of having a jus quaesitum, or by evidence that the tertius knew of the provision intended for his benefit."[4]

1. Dunlop Pneumatic Tyre Co. Ltd. v. Selfridge & Co. Ltd., /‾1915_7 A.C. 847, at p. 853. Cf. Denning L. J. (as he was then) in Smith and Snipes Hall Farm Ltd. v. River Douglas Catchment Board, /‾1949_7 2 K.B. 500, at p. 514. See also Dowrick, "A Jus Quaesitum Tertio by way of Contract in English Law": (1956) 19 M.L.R. 374; and Furmston, "Return to Dunlop v. Selfridge": (1960) 23 M.L.R. 373.
2. I, 10, 5.
3. Carmichael v. Carmichael's Exrs., 1920 S.C. (H.L.) 195, at p. 201.
4. Principles of Scottish Private Law, 2nd ed., at 628-629.

Once it is established that the third party has a jus quaesitum, then he is entitled to enforce the performance of the contract as between the contracting parties.

Thus a beneficiary of a Scottish trust may be entitled to enforce performance of the trustees' duties by means of a jus quaesitum. This right of the beneficiary is not recognised in England where, although it may be established that an enforceable contract exists between the trustees and the settlor, the beneficiary has no right at common law to enforce that contract.

It was noted above that the roots of the law of trusts in Scotland lie in the contracts of mandate and depositum. However, it is doubted by many writers of more recent times whether the modern concept of trust can be considered in terms of the nominate contracts. It is argued in the Encyclopaedia of the Laws of Scotland that 'in neither mandate nor deposit does the property vest in the mandatary or depositary, whereas in trust the property vests in the trustee.[1] McLaren considered the trust not as mandate but as quasi-contract.[2] Doubts are also expressed in Gloag and Henderson:

> " ... the obligation involved in a position of trust or in certain fiduciary relationships extends so far beyond what the party who accepted the position may have intended, and are so often owed to parties with whom he clearly had no direct contractual relation, that it is more in accordance with modern decisions to regard trust, or fiduciary relationship, as an independent source of obligation."[3]

It is now accepted that in the modern Scottish law of trusts, not only may the beneficiary enforce performance of the mandate by means of a jus quaesitum, he also has a right to compel the trustees to perform a duty which is owed by trustees to their beneficiaries. This duty is, in effect, equivalent to the duty

1. Vol. 15, para. 362.
2. Law of Wills and Succession, 3rd ed., II, at p. 825.
3. Introduction to the Law of Scotland, 6th ed., at p. 30.

imposed on trustees in England; a duty which was established in the Court of Chancery.

The English infiltration into the law of Scotland was highlighted by the Lord President in Allen v. M'Combies's Trs.[1] The Lord President accepted that it may be historically true that the Scottish law of trusts is derived from the contracts of deposit and mandate, but he considered that it would be wrong to apply the law of these two contracts only when dealing with matters concerning trust.[2] He determined that the law of the Court of Chancery is now engrafted onto the original Scottish law of trusts,[3] and that a trustee in Scotland owes a duty to his beneficiaries as does a trustee in England; this duty is not derived from the law of contract but from the principles of equity established in the Court of Chancery. He did not in any way suggest that the laws of deposit and mandate are no longer applicable to trusts; these are in addition to the principles derived from England. Lord Kinnear in the same case supported the Lord President:

> " ... there can be no doubt that we have derived the law of trust as now administered much more directly, through the aid of the decisions of the House of Lords, from the equitable administration of trusts by the Court of Chancery in England, than by any logical deduction from the strictly legal conception of the contracts [of mandate and deposit] ... But whatever be the origin of the legal conception of trust it has wider consequences in the fiduciary relation which it creates than can be referred to contract."[4]

Thus, a fundamental difference between the Scottish and English law of trusts lies in the jus quaesitum of the Scottish beneficiary. The Scottish beneficiary has two possible actions against a trustee. He has the equivalent of the English beneficiary to sue for breach of trust; he may also have a jus quaesitum to enforce performance of the mandate.

1. 1909 S.C. 710.
2. Ibid., at p. 716.
3. Ibid., at p. 717.
4. Ibid., at p. 720.

APPENDIX 2. TRUST AND AGENCY DISTINGUISHED

There are many differences between the two legal concepts of trust and agency; however, both are in the nature of a fiduciary relationship and this to a certain extent confuses the distinction. Dowrick noted:

> "Agency has often been described as a fiduciary relation. Historically the doctrine of fiduciary relations is an extension of the law of trusts."[1]

The fiduciary relationship itself is a nebulous concept. According to Shepherd:

> "A fiduciary relationship exists whenever any person receives a power of any type on condition that he also receives with it a duty to utilise that power in the best interests of another, and the recipient of the power uses that power."[2]

It is because the laws which govern the acts of those in a fiduciary position are applicable to both trustees and agents that the distinction between the two concepts is blurred. For example, the rule that a fiduciary must not allow his interest and duty to conflict[3] is found to apply to both trustees[4] and agents.[5]

The distinction is further confused by the dual role which may be played by an agent who purchases property in his own name but on behalf of his principal. The agent holds the property in trust;

1. "Relationship of Principal and Agent": (1954) 17 M.L.R. 24, at p. 28.
2. "Towards a Unified Concept of Fiduciary Relationships": (1981) 97 L.Q.R. 51, at p. 75.
3. Bray v. Ford, [1896] A.C. 44 (esp. Lord Hershell at p. 51).
4. Williams v. Barton, [1927] 2 Ch. 9.
5. Parker v. McKenna, (1874-1875) 10 Ch. App. Cas. 96. M'Phersons's Trustees v. Watt, (1877) 5 R. (H.L.) 9. For other fiduciary duties see generally Shepherd, (1981) 97 L.Q.R. 51, at p. 51.

the beneficiary under the trust is the principal.[1] In Longfield Parish Council v. Robson[2] the clerk to Longfield Parish Council was nominated by the Council to purchase land on its behalf. The land was conveyed to the clerk who refused to convey it to the Council. The court decided that the clerk held the land as a trustee on behalf of the Council.

The principle was recognised by Lord Dunfermline in Bank of Scotland v. Liquidators of Hutchinson Main and Co. Ltd., who observed:

> "When an agent obtains money for the specific purpose of purchasing a property for his client and takes the title in his own name, and becomes bankrupt, it is clear that in such a case the law will get behind the apparent title to the beneficial and the real title, and that - always granted that the interests of third parties who have bought upon the faith of the records have not arisen - the property will, in the event of bankruptcy, be correctly treated as never having been in bonis of the debtor, but always of the client."[3]

The basic distinction between trust and agency lies in the concept of ownership. In Menzies on Trustees it is provided:

> "The most distinctive characteristic of the office of trustee is ownership. A trust, in the legal sense, can only exist in reference to property."[4]

The proposition is demonstrated by reference to the procedure of English law:

> "This characteristic of ownership, as the real criterion of proper trusteeship, is sharply illustrated by the procedure of the English law, where a trustee proper, being vested with legal estate, cannot be sued by the beneficiary in an action law, but only in a personal suit in equity. An agent though liable in a fiduciary capacity in equity, can also, as he is not vested with the legal estate of the property in his possession, be sued in an action at law."[5]

1. Bank of Scotland v. Liquidators of Hutchinson & Main & Co. Ltd., 1914 S.C. (H.L.) 1; and Lees v. Nuttall, 39 Eng. Rep. 1157.
2. (1913) 19 T.L.R. 357.
3. 1914 S.C. (H.L.) 1, at p. 15.
4. 2nd ed., section 5.
5. Ibid.

Thus a trustee acts with reference to property whereas an agent has a power to affect the legal relationships of his principal. An agent is to a greater extent under the control of his principal, but a beneficiary generally has no right to dictate the way in which his trustee is to deal with the trust property. Snell summarised the distinction thus:

> "An agent and a trustee resemble each other in that each is subject to fiduciary obligations towards his principal or beneficiaries, as the case may be. But there are many differences. Trusts are governed by equity, agency by common law. In most trusts, there is no contractual relationship between the trustees and the beneficiaries, whereas apart from agents of necessity agency normally arises by contract between a principal and agent. Usually a trustee has property vested in him, whereas an agent does not; and while a trustee usually cannot involve his beneficiaries in liability, an agent can make his principal liable."[1]

1. Principles of Equity, 27th ed. at p. 89-90.

APPENDIX 3. THE NATURE OF THE INTEREST OF THE BENEFICIARY

The decision of the House of Lords in Baker v. Archer-Shee[1] is considered in detail in the main text above. It is intended here to present a concise discussion on the nature of the beneficiary's interest according to the laws of Scotland and England: the decision in the Archer-Shee case is, however, ignored.

Scotland

Bell described the beneficial interest under a trust as follows:

> "This is in its nature a jus crediti, and has preference over the private creditors of the trustee, while it is effectual against the truster's creditors by the real right vested in the trustee for behoof of those entitled to the trust ... This jus crediti gives a personal right of action against the trustee."[2]

Walker noted that the 'interest of a beneficiary under a trust deed is a jus crediti, enforceable by action against the trustees but not against any debtor to the trust estate.'[3] Judicial authority for this proposition is found in the case of I.R.C. v. Clark's Trs., in which Lord President Normand stated:

> " ... the beneficiary's right is nothing more than a personal right to sue the trustees and compel them to administer the trust in accordance with the directions which it contains ..."[4]

Lord Moncrieff concurred with the Lord President:

> "In my view, the right of property in the estate of the trust is vested in the trustees to the exclusion of any competing right of property, and the right of the beneficiary ... is merely a right in personam against the trustees to enforce their performance of the trust. It is true that, in the assertion of that right, a beneficiary will in certain cases obtain the aid of the Court to enable him to use the

1. (1927) 11 T.C. 749.
2. Principles of the Law of Scotland, at s. 1996.
3. Principles of Scottish Private Law, 2nd ed., at p. 1829.
4. 1939 S.C. 11, at p. 22.

names of the trustees, but it is only as representing the trustees in such a case that he can attach or assert any property right over the assets of the trust."[1]

However, it would appear that a beneficiary who is absolutely entitled to property held by trustees is treated as possessing a proprietary right in the trust res. The trustees in such a case act as 'nominees' or 'bare trustees' who are required to convey the property to the beneficiary at his request. Smith submitted that 'the beneficiary's right against the trustee is a personal right - a jus in personam - in some cases a jus ad rem, when the beneficiary is entitled to have conveyed to him some specific property.[2] Support for Smith's submission is provided by the estate duty case of Parker v. Lord Advocate[3] the facts of which were as follows.

During the life of the truster the beneficiaries were entitled to enjoy the free income from the settled funds. On the truster's death, the funds were to be divided equally between the beneficiaries. The truster died and the question of estate duty arose. Estate duty was chargeable on the value of the property which passed on the death of a person. Property passing on the death of a person was deemed to include 'any annuity or other interest purchased or provided by the deceased ... to the extent of the beneficial interest accruing or arising by survivorship or otherwise on the death of the deceased'. The trustees argued:

"Certainly some beneficial interests ... accrued or arose, but they did not extend to the whole capital of the trust fund since previously the children were entitled to beneficial interests in possession in the income, and allowance should be made for these, because after the death of the deceased the children simply continued to be entitled to the income under the provisions of the deed."[4]

1. Ibid. at p. 26.
2. Short Commentary on the Law of Scotland, at p. 573.
3. 1960 S.C. (H.L.) 29.
4. Ibid at p. 31.

They suggested that the interests of the beneficiaries were similar both before and after the death of the truster and that therefore the value of the beneficial interests accruing on the death of the truster was minimal. The House of Lords had little sympathy with this contention. The view of the House was succinctly stated by Lord Keith of Avonholm:

> "But granted they [the beneficiaries] enjoy the same income, the income before and after the death is derived from quite different rights. Before the truster's death there was merely a right in the children to call the trustees to account for their administration of the trust and to pay to them the income arising - Inland Revenue v. Clark's Trustees 1939 S.C. 11. After the death their income derived from ownership of the corpus of the trust estate vested in them for the first time on the death of the truster. These are radically different rights."[1]

After the death of the truster the capital was payable to the beneficiaries: although the trustees held the capital it was thought by the House that the beneficiaries were the owners of the trust fund. Their right was described by Lord Mackintosh in the Court of Session as a 'jus in re, a real right in the trust fund.'[2] Thus during the life of the truster the beneficiaries' interests were rights in personam - against the trustee; but after his death the beneficiaries became absolutely entitled to the trust property and were treated as having acquired a proprietary right - a jus in re.

The Scottish bankruptcy cases fit rather awkardly within the general theory outlined above. S. 102 of the Bankruptcy (Scotland) Act 1856 reads:

> "The act and warrant of confirmation in favour of the trustees shall ipso jure transfer to and vest in him, or any succeeding trustee, for the behoof of the creditors, absolutely and irredeemable, as at the date of the sequestration, with all right, title, and interest: the whole property of the debtor, to the following effect ... "

1. Ibid. at p. 41.
2. 1959 S.L.T. 65, at p. 71.

Where a debtor appeared on the face of public records to be the absolute owner of property but had by an unregistered back letter declared himself trustee of that property for another, did the 'whole property' of the debtor which transferred on sequestration to the trustee in bankruptcy include the property held by the debtor on latent trust? This was the problem presented to the House of Lords in Heritable Reversionary Co. Ltd. v. Millar.[1]

M bought land in his own name; the disposition was recorded in the Register of Sasines. M executed a declaration of trust on behalf of the Appellants for whom he had purchased the property: the declaration was unrecorded. M was declared bankrupt. The House decided that the property held on trust did not pass to the trustee in bankruptcy under s. 102. Lord Watson suggested that the debtor M merely had an apparent title to the property but had no real right:

> "An apparent title to land or personal estate, carrying no real right of property with it, does not, in the ordinary or in any true legal sense, make such land or personal estate the property of the person who holds the title. That which, in legal as well as in conventional language, is described as a man's property is estate, whether heritable or moveable, in which he has a beneficial interest which the law allows him to dispose of."[2]

The decision was approved by the House of Lords in the later case of Bank of Scotland v. Liqrs. of Hutchinson Main & Co., Ltd.[3] However, it is submitted that the statement of Lord Watson is a little too extensive.

The statement is acceptable in so far as it relates to property held by nominees or bare trustees on behalf of a beneficiary who has the power to call for a conveyance of the trust property to himself. In this respect it is consistent with the decision in

1. (1892) 19 R. (H.L.) 43.
2. Ibid. at p. 47.
3. 1914 S.C. (H.L.) 1.

Parker v. Lord advocate[1] and with the submission of Smith which is set out above.[2] However, in so far as it relates to property held on behalf of a mere liferenter who has no power to call for a conveyance, the statement is not consonant with the prevailing authority. It must be confined within narrow limits; Wilson and Duncan suggested:

> "It may be that this problem, like many others in Scots law, is one of semantics and that these dicta referred to 'property' as used in the Bankruptcy Acts."[3]

The problem as to the nature of the beneficiary's interest is inextricably associated with the notion that the trustees are able to transfer property free from the trust to a bona fide purchaser for value who takes without notice of the trust. In Millar's case it was necessary for the Lords to explain how such a purchaser could receive a good title to trust property from trustees who, according to the Lords, had no real property to transfer. Lord Watson in Millar's case provided:

> " ... the validity of a right acquired ... by a bona fide disponee for value does not rest upon the recognition of any power in the trustee which he can lawfully exercise, ... but upon the well known principle that a true owner who chooses to conceal his right from the public, and to clothe his trustee with all the indicia of ownership, is thereby barred from challenging rights acquired by innocent third parties for onerous consideration under contracts with his fraudulent trustees."[4]

It was the House of Lords in Redfearn v. Sommervails & Co.[5] that first established the principle that a purchaser for value of trust property who acts in good faith and without notice of the trust takes that property free from the trust. The facts in

1. 1960 S.C. (H.L.) 29.
2. Supra., at xii.
3. At p. 15.
4. (1892) 19 R. 43, at p. 47.
5. (1813) 3 Eng. Rep. 618.

the case were as follows: A held a share on latent trust for B. A assigned the share to C for onerous cause. The court was required to determine the competing claims of B and C. The Court of Session held that the assignee (C) could take no better title than the assignor (A) had; he took therefore subject to the latent equity. The decision was based on the rule that where a creditor assigns a debt, the debtor may use any right of set-off against the assignee that he could have exercised against the original creditor.

The House of Lords reversed the Court of Session's decision. The assignee (C) was not in the position of an assignee of a debt who could enquire of the debtor how the debt stood. C did not know of the beneficiary; he could not therefore have enquired of B as to the interest of B in the shares. Lord Eldon argued:

> "If latent equities were suffered to prevail against assignations, the effect would be that nothing could ever be assigned; for as long as their Scotch neighbours retained any part of their characteristic shrewdness, they would never take an assignment if they were aware that by means of latent equities such assignments might give them nothing."[1]

There is no suggestion here that the trustee had no real property to transfer or that the beneficiary was personally barred from asserting property rights against the bona fide purchaser for value. The rationale for the rule is clearly to promote safety in commercial transactions. The notion of personal bar may serve to alleviate the position of the purchaser from bare trustees who, it would appear, have no real title to transfer. However, in respect of trustees (other than bare trustees), on the basis of Redfearn v. Somervail & Co. the purchaser receives the property free from the trust in order to promote safety in commercial transactions.

It is only safe to conclude that, unless the beneficiary is entitled to call for a conveyance of the trust property, he has no right of ownership therein: he has a personal right of action against the trustees - a jus in personam. As Smith submitted, there is 'no suspicion that the law of Scotland recognises anything in the nature of different but concurrent rights of ownership in the trustee and beneficiary.'

1. Ibid, at p. 626.
2. Short Commentary on the Law of Scotland, at p. 573.

England

Prior to the decision in Baker v. Archer-Shee[1] it was a commonly held belief that the interest of a beneficiary under a trust was a mere jus in personam - to compel due administration of the trust. The topic was not entirely free from confusion though what confusion there was stemmed more from a looseness of language than from any fundamental conflict of concepts. Maitland noted:

> "This is a topic which, as it seems to me, is insufficiently explained in some of our elementary text-books. Language is there used about one person being the owner at law while another is the owner in equity in which there is no harm, provided it be properly understood; but it does not explain itself and is liable to lead to serious mistakes, not merely to unsound theories but to practical blunders."[2]

Maitland maintained that the rights of the beneficiary are essentially jura in personam; they are rights against certain persons and not jura in rem, rights against the world at large.[3] The beneficiary has no proprietary rights in the trust res. The confusion that Maitland noted, that it is common to speak of the beneficiary as the owner in equity of the trust res, arises by reason of the uncanny resemblance that the beneficiary's interest bears to a property right.

The beneficiary's interest developed the appearance of a proprietary right in a series of stages; Maitland catalogued the development.[4]

(i) In the first place the beneficiary has a remedy against the person who has undertaken to hold land or goods for him. The right is clearly in personam.

(ii) The rights can be enforced against the heirs and successors of the original trustee.

1. (1927) 11 T.C. 749.
2. Equity, 2nd ed., at p. 106.
3. Ibid., at p. 107. See also Coke - ' ... cestui que use had neither jus in re nor jus ad rem, but only a confidence and trust.' (Co.Litt. 272 b)
4. Equity, 2nd ed., at p. 112-114.

(iii) The trust can be enforced against the creditors of the trustee.

(iv) The beneficiary may enforce his right against anyone who receives trust property gratuitously from the trustee. At this stage Maitland observed that 'the cestui que trust's right [is] beginning to look real.'

(v) The trust can be enforced against one who has received trust property for valuable consideration but who had notice of the trust. The rationale for this rule according to Maitland, is that it 'is unconscientious - 'against conscience' - to buy what you know is held on trust for another.'

(vi) The trust is enforceable against one who has received trust property for valuable consideration and who did not know of the trust, but his ignorance was due to his lack of diligence; this is the notion of constructive or presumed notice.

The trust may therefore be enforced against a number of persons other than the original trustee: the beneficiary's interest clearly has many semblances of a proprietary right.

> "But here a limit was reached. Against a person who acquires a legal right bona fide, for value, without notice express or constructive of the existence of equitable rights those rights are of no avail."[1]
>
> "Equity cannot touch him, because, to use the old phrase, his conscience is unaffected by the trust.
>
> "The result to which we have attained might then, as it would seem, be stated in one of two alternative ways.
>
> "(1) Cestui que trust has rights enforceable against any person who has undertaken the trust, against all who claim through or under him as volunteers (heirs, devisees, personal representatives, donees) against his creditors, and against those who acquire the thing with notice actual or constructive of the trust.
>
> Or (2) Cestui que trust has rights enforceable against all save a bona fide purchaser ('purchaser' in this context always includes mortgagee) who for value has obtained a legal right in the thing without notice of the trust express or constructive."[2]

1. Ibid., at p. 114.
2. Ibid., at p. 115.

As Hart noted, the right of the beneficiary 'ought to be regarded as jus in personam since, although it can be enforced against a great many people, it cannot be enforced against everybody.'[1]

This is not, however, to suggest that a beneficiary has no rights in rem. He has, as Langdell has indicated, a right in rem in the equitable obligation of the trustee, that is, the equitable chose in action. Langdell noted:

> "Regarding the equitable obligation itself as the res, there can be no doubt that an equitable obligation, like a legal obligation always creates a right in rem (i.e., an absolute right), as between the obligee and the rest of the world except the obligor; for it can create a right in personam (i.e., a relative right) only between the obligee and the obligor. To say, therefore, that an obligation can create a relative right only, is to say that it can create no right whatever, except as between the obligee and obligor. Moreover, if an obligation does not create an absolute right, it is impossible to support Lumley v. Guy and Bowen v. Hall, though the converse does not necessarily follow."[2]

Lumley v. Guy[3] and Bowen v. Hall[4] are authorities for the proposition that the acts of a stranger which interfere with a contract so preventing the obligee from enjoying its performance are actionable wrongs. The right of an obligee against the obligor gives rise to a negative duty imposed on the world at large not to interfere with the obligee's right in personam. Ames explained:

> A cestui que trust is frequently spoken of as an equitable owner of the land. This, though a convenient form of expression, is clearly inaccurate. The trustee is the owner of the land, and, of course, two persons with adverse interests cannot be owners of the same thing. What the cestui que trust really owns is the obligation of the trustee; for an obligation is as truly the subject-matter of property as any physical res.

1. "The Place of the Trust in Jurisprudence": (1912) 28 L.Q.R. 290. at p. 297.
2. A Brief Survey of Equity Jurisdiction, 2nd ed., 6, n 1.
3. (1853) 118 Eng. Rep. 749.
4. (1881) 6 Q.B.D. 333.

> The most striking difference between property in a thing and property in an obligation is in the mode of enjoyment. The owner of a house or a horse enjoys the fruits of ownership without the aid of any other person. The only way in which the owner of an obligation can realize his ownership is by compelling its performance by the obligor. Hence, in the one case, the owner is said to have a right in rem, and, in the other, a right in personam. In other respects the common law rules of property apply equally to ownership of things and ownership of obligations. For example, what may be called the passive rights of ownership are the same in both cases. The general duty resting upon all mankind not to destroy the property of another, is as cogent in favour of an obligee as it is in favour of the owner of a horse. And the violation of this duty is as pure a tort in the one case as in the other.[1]

Very much in the minority is the opinion of Scott who, although accepting the proposition of Langdell, argued that a beneficiary also has a proprietary right in the trust res; he suggested that it is not wrong to speak of a beneficiary as an equitable owner. Scott maintained that the courts 'speaking of conscience, of presumed notice, of unjust enrichment' may not always have realized that they were in fact attributing to the beneficiary property rights in the trust res, and that the subjection to the trust of donees of trust property who have taken without notice involves a recognition of a proprietary right in the beneficiary.[2]

Scott further maintained that it is not by reason of some principle based on considerations of 'conscience' that the purchaser for value of property without notice of the trust takes the property free of the trust. The purchaser takes the property because the law requires that commercial transactions must be protected. Thus, according to Scott, the beneficiary has a real right in the trust property, but, as the law requires that commercial transactions must be protected, the right cannot prevail against a bona fide purchaser for value without notice of the trust.[3]

1. "Purchaser For Value Without Notice": (1887) 1 Harv. L.R. 1, at p. 9-10.
2. "The Rights of the Cestui Que Trust": (1917) 17 Col. L.R. 269, at p. 283.
3. Ibid., at p. 280.

The present writer does not pretend that justice has here been done to the elaborate arguments produced by Scott in support of his thesis. However, it is submitted that the proposition that a beneficiary has no propietary interest in the trust property was convincingly reaffirmed by Stone in his reply to Scott's article.

Unlike Scott, Stone was not prepared to dismiss to such an extent the notion of conscience as the basis for the subjection of certain persons to the trust. Stone argued (mainly on the basis of American decisions)[1] that liability is imposed on a donee of trust property only when that donee becomes aware that the property was the subject of a trust:

> "He [the donee] must not only interfere with the trust property, but his liability is dependent upon his knowledge that he is interfering with the right which the cestui has against the trustee. That is to say, his liability is fixed only when his conscience is affected. Thus, the innocent donee is not liable to the cestui until he knows that, by his possession and retention of the trust property, he is interfering with the right of the cestui. If he gave the property away before notice, he would not be liable for his interference with the trust property and he might reacquire the property from his subsequent bona fide purchaser without incurring any liability to the cestui, although a strict trustee may not repurchase the trust property from the bona fide purchaser and hold it free of his personal obligation to the cestui. The duty arises when his conscience is affected. These results indicate that the test of liability of the third person, in every case, whether a purchaser or donee, is conscious interference with the right of the cestui. It is his act, accompanied with knowledge of the cestui's right, which fixes upon the third person the obligation in personam, without which there can be no right against the third person."[2]

The significance of Stone's observations is that it is not a proprietary right of the beneficiary in the trust res which imposes the liability on a donee of trust property, but the right which gives rise to a negative duty in the world at large not to deliberately

1. Bonesteel v. Bonesteel (1872) 30 Wisc. 516: Gidding v. Eastman (N.Y. 1835) 5 Paige Ch. 561.
2. "The Rights of the Cestui Que Trust": (1917) 17 Col. L.R. 467, at p. 484.

interfere with the obligation of the trustee to the beneficiary. Where a bona fide purchaser for value of trust property subsequently becomes aware of the trust he is, by retaining the property, deliberately interfering with the beneficiary's equitable chose in action against the trustee. However, Stone, in agreement with Scott, suggested that no liability attaches to the purchaser because the law requires that commercial transactions must be protected.[1] Stone summarized his thesis thus:

> " ... it is believed that the view of the nature of the right of the cestui que trust most consistent with the decisions and which gives greatest promise of the development of the law upon a moral basis is that the right of the cestui is a right in personam against the trustee, specifically enforceable with reference to the trust res; that the cestui acquires rights in personam against third persons, not because he is equitable owner of the trust res, but through equity's imposing upon third persons, obligations in personam, because of their unconscientious interference with the right which the cestui has against the trustee; that, therefore, equity imposes on all the world the duty of not consciously aiding in a breach of trust or preventing the cestui from having the benefit of the obligation of the trustee."[2]

Thus, apart from the decision in Baker v. Archer-Shee, it would appear that the beneficiary of an English trust has no proprietary right in the trust res. As Hanbury has indicated, the lawyer adopts lay phraseology and talks loosely of 'equitable ownership' merely to avoid the imputation of 'prigishness'.[3]

It was noted in Appendix 1 that the modern law of trusts in Scotland has to a considerable extent been derived from the decisions of the English Court of Chancery.[4] It is not therefore surprising that the nature of the beneficiary's interest according to the legal theory of both countries should be similar. In his analysis of the nature of the beneficiary's interest in Scotland Smith stated:

1. Ibid., at p. 484.
2. Ibid., at p. 500.
3. "A Periodical Menace to Equitable Principles": (1928) 44 L.Q.R. 486, at p. 486.
4. Supra, at p. vii..

> "It must be stressed, however, that no good and much harm can result from seeking to graft onto Scots law the characteristically English dichotomy of 'legal' and 'equitable' ownership."[1]

The statement is unfortunate in that Smith assumed that there is a dichotomy of 'legal' and 'equitable' ownership in England: it has been shown that this is not the case. Conceptually, the Scottish trust is barely distinguishable from its English counterpart. It is only the Archer-Shee decision that casts doubt on this proposition.

1. Short Commentary on the Law of Scotland, at p. 549.

APPENDIX 4. SECTION 451, I.C.T.A. AND THE FINANCE BILL 1981

The Finance Bill 1981 proposes several amendments and reliefs to the operation of s. 451, I.C.T.A. These proposals are discussed in general terms below.[1]

A) Payment of a capital sum indirectly to the settlor

Clause 41(7) seeks to rationalize the somewhat arbitrary rules in respect of capital sums paid indirectly to the settlor by the trustees of a settlement. It will be recalled that a sum paid to a third party is caught by s. 451 only if that third party is accountable to the settlor or his spouse.[2] .Thus, capital sums paid to the creditors of the settlor in discharge of his debts are not taxable as his income. A capital sum so paid, in effect, benefits the settlor as much as a sum paid to a third party who is accountable to the settlor. However, the sum paid to the accountable third party is taxable under s. 451

In clause 41(7) it is proposed that a capital sum which (1) is paid by the trustees to a third party at the settlor's direction or by virtue of the assignment of the settlor's right to receive it, or (2) is otherwise paid or applied by the trustees for the benefit of the settlor, shall be treated as if it had been paid to the settlor.[3]

B) The extent to which a capital sum is treated as income

A capital sum paid by the trustees to the settlor may be treated as his income to the extent that it falls within the income available at the end of the year in which it is paid or in subsequent years.[4]

1. Unless otherwise stated, reference in this appendix are to the Finance Bill 1981.
2. Lord Normand in Potts' Executors v. I.R.C., (1950) 32 T.C. 211, at p. 229; supra, at p. 137.
3. The proposal is intended to operate from 6th April, 1981.
4. S. 451(1); supra, at p. 139.

The amount of income available at the end of any year for the purposes of s. 451(1) is the amount of income arising under the settlement in that year and any previous relevant year which has not been distributed, minus the deductions specified in paras (a) to (e) of s. 451(2).[1] Clause 41 proposes that several other deductions should be allowed in addition to those currently allowed in s. 451(2).

Thus, for the purposes of ascertaining the amount of income available at the end of any year it is proposed that there should be deducted from the undistributed income of the settlement arising in that and any previous relevant year:

1) the amount of income which has been taken into account in previous years in determining the amount of a capital sum to be treated as the income of the settlor in those previous years;[2]
2) the amount of income arising under the settlement in that and any previous relevant year which has been treated as the income of the settlor under s. 457;[3] and
3) the amount of any sums paid by virtue or in consequence of the settlement and which have been treated as the income of the settlor under s. 438(2)(b), I.C.T.A.[4]

Para. (e)(ii) of s. 451 is amended to take account of the proposed deductions at 2) and 3) above.[5]

C) The amount of tax payable by the settlor

Where a capital sum is treated as the income of the settlor under s. 451, the amount of income attributed to him is an amount equal to the sum received grossed up at the basic and additional rate of tax.[6]

1. Supra at p. 140.
2. The purpose of this proposal is evident from the remarks of Lord Reid in I.R.C. v. Bates, (1966) 44 T.C. 225, at p. 261-262; supra, at p. 141.
3. Supra, at p. 142.
4. Supra, at p. 143.
5. The proposal is intended to affect capital sums paid after 6th April, 1981.
6. S. 451(5) , I.C.T.A., supra, at p. 144.

Although the settlor will be liable to income tax on the grossed up amount of the capital sum it is proposed in clause 41(5) that there is to be set against the amount of tax chargeable an amount equal to (a) the sum of tax at the basic and additional rate for that year on the amount treated as income; or (b) so much of that sum as is equal to the tax charged, which ever is the less.

In effect, the capital sum will be grossed up only for the purposes of assessing the amount at the higher rates of tax of the settlor.[1]

D) Capital sums paid by way of loan

Clause 41(4) proposes that where a capital sum is paid to the settlor by way of loan and is repaid in full, no part of the sum may be treated as income of the settlor under s. 451(1) for any year of assessment after that in which the repayment is made.

If one or more previous loans have been made and repaid in full, relief may be available in respect of a subsequent loan. The amount of the subsequent loan is to be reduced by the amount of the previous loans which has been treated as the income of the settlor.

It is further proposed that relief should be available in respect of a capital sum paid by the trustees to the settlor by way of complete repayment of a loan. The relief is to be available where subsequent to the complete repayment, the settlor makes a further loan to the trustees of an amount not less than the amount repayed. If this condition is satisfied, the capital sum (the amount of the original loan repayed to the settlor) is not to be treated as the income of the settlor after the year in which the further loan is made.[2]

1. The proposal is intended to affect capital sums paid after 6th April, 1981.
2. The proposal is intended to affect capital sums paid after 6th April, 1981.

E) Capital sums paid by bodies corporate connected with the settlement

Clause 43(2) proposes to substitute s. 454(4), I.C.T.A. S. 454(4) provides the criteria for determining whether or not a body corporate is connected with a settlement. It is proposed that the new s. 454(4) will provide:

> " ... a body corporate shall be deemed to be connected with a settlement in any year of assessment if at any time in that year -
>
> (a) it is a close company (or only not a close company because it is not resident in the United Kingdom) and the participators then include the trustees of the settlement; or
> (b) it is controlled within the meaning of section 534 below by a company falling within paragraph (a) above."

S. 454(4) as it now stands provides that a close company is connected with a settlement if the participators include either the trustees of the settlement or the beneficiary. Para. (b) of the proposed s. 454(4) is an addition to the section.

Clause 42(1) proposes that a capital sum paid to the settlor by a body corporate connected with the settlement shall be treated as if it had been paid by the trustees to the extent that it falls within the total amount of 'associated payments' made by the trustees to the body corporate.

An 'associated payment' is a capital sum (or other sum paid or asset transferred otherwise than for full consideration) paid to the body corporate by the trustees within five years of the date on which the capital sum was paid to the settlor by the body corporate.

If the capital sum paid by the body corporate to the settlor exceeds the amount of associated payments made up to the end of the year in which the capital sum is paid, then a carry forward provision is to operate. Thus, the excess may be treated as if it were paid by the trustees in subsequent years to the extent that it falls within the total amount of associated payments made in those subsequent years.

In general, there is to be no charge to tax on the settlor if the capital sum paid by the body corporate is made by way of loan or repayment of a loan and the settlor repays to the body corporate an amount equal to the capital sum within twelve months of the date on which it was paid to him.[1]

1. The proposal is intended to affect capital sums paid after 6th April, 1981.

ADDENDUM

Piratin v. I.R.C.[1]

Piratin v. I.R.C. was a case involving the notorious s. 451, I.C.T.A. The taxpayer was the settlor of a trust constituted in 1967. He operated a running account with a close company, S.L.P., which was connected with the settlement. Applying I.R.C. v. Bates[2], Slade, J. held that each withdrawal from the account represented a repayment of a loan; the sums withdrawn were, therefore, capital sums paid directly to the settlor and were accordingly taxable under s. 451(1). It was immaterial that the sums were paid to the settlor in the course of a running account.

In 1972 the settlor deposited various sums with Oceanic, a close company also connected with the settlement. In the same year Oceanic transferred those sums to B. Ltd. at the settlor's request. On receipt of these sums B. Ltd. became contractually bound to pay to the settlor on demand an amount equal to the amount transferred by Oceanic.

The Crown argued that Oceanic, by transferring the funds to B. Ltd., had indirectly paid a capital sum to the settlor with s. 451(1).

The Crown's contention was dismissed. B. Ltd. was not in law strictly accountable to the settlor for the sums transferred; B. Ltd. was merely contractually bound to pay to the settlor an equivalent sum. This did not satisfy the strict accountability test laid down in Potts' Executors v. I.R.C.[3] to determine if a sum is paid 'indirectly' to a settlor for the purpose of s. 451.

1. [1981] S.T.C. 441.
2. (1966) 44 T.C. 225.
3. (1950) 32 T.C. 211.