

TAXREP 36/05

TRUST MANAGEMENT EXPENSES

Memorandum submitted in August 2005 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an invitation to comment on draft guidance issued in June 2005 by HM Revenue & Customs.

CONTENTS

	Paragraph
INTRODUCTION	1-2
KEY POINT SUMMARY	3
GENERAL COMMENTS	4-6
DETAILED COMMENTS	7-32
	Annex
WHO WE ARE	A
TEN TENETS FOR A BETTER TAX SYSTEM	B

Tax Representation

TRUST MANAGEMENT EXPENSES

INTRODUCTION

1. We are grateful for the opportunity to comment on the second draft of the Trust Management Expenses Explanatory Note which was published as a discussion paper by HM Revenue & Customs (HMRC) in June 2005. The draft explanatory note can be found at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_83630. The Tax Faculty's comments on the first draft of HMRC's explanatory note, submitted on 15 November 2004 and published as TAXREP 57/04, can be found at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_73514
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A to this document.

3. KEY POINT SUMMARY

We welcome the fact that the draft explanatory note adopts some of our suggestions made in response to the previous consultation, and is more helpful as a result. Certain uncertainties remain to be clarified, in particular:

- More detail could be provided on what types of expenses are regarded as 'ordinary outgoing of a recurrent nature, such as rates and taxes and interest on charges and encumbrances' (Lord Templeman in *Carver v Duncan* [1985] STC 356).
- The concept of 'husbanding' the income fund is mentioned in paragraph 2.5 in relation to expenses chargeable to income. It is not clear how this compares with 'ordinary outgoing of a recurrent nature.' Some examples at that point might illustrate which expenses are chargeable to income or capital funds.
- Expenses that are incurred for the benefit of the whole fund are properly payable out of capital. However, for certain types of expenses it has become common practice to allow an apportionment between income and capital. It is not clear why in some cases there is an all or nothing approach and in others apportionment is allowed.
- Since the explanatory note will be of interest to practitioners we think that statements such as 'husbanding' the income fund (paragraph 2.5) should include a reference, preferably by way of footnote, to the statutory or judicial authority for the statement.

GENERAL COMMENTS

4. We are pleased that some of our comments on the earlier draft have been adopted and we consider that the explanatory note is more helpful as a result. The current draft is well written, clear and will be of assistance to practitioners in setting out HMRC's current views on the topic. In our earlier submission we welcomed the collaborative

Tax Representation

approach of seeking the views of the professions before issuing your conclusions on the subject to the public. We hope you have found it helpful. It may of course have identified areas of disagreement but that is also constructive.

5. The fact that it takes 16 pages to explain the tax treatment of trustees' expenses illustrates how complicated the subject is. It is also an area of considerable uncertainty. The draft paper is helpful in removing some uncertainties although some remain: notably trustees' remuneration. Although it is a separate matter not within the scope of the guidance note, some of the complications and uncertainties can only be removed by legislation. That is one of the tasks of the consultations on the Modernisation of the Taxation of Trusts in which we have been participating. We submitted in June 2005 our comments (TAXREP 27/05) on the consultation paper issued in March 2005, including some comments on trustees' expenses and we look forward to commenting on the draft legislation when it is available. In this regard we attach our Ten Tenets for a Better Tax System in Annex B. TAXREP 27/05 can be found at the following link:
http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_82399
6. We understand that you intend to publish the explanatory note without including a section on the treatment of trustees' remuneration. It would be helpful to publish the additional guidance on trustees' remuneration after further consultation. However, in the interests of fairness to all taxpayers the divergence of views should be explained and if formal litigation has begun we think it would be helpful if you state that fact in the explanatory note.

DETAILED COMMENTS

Paragraph 2.3

7. The authority for the 'four sources' would be a helpful addition to this paragraph. Also it is not clear what is meant by 'the final incidence of trust expenses.'

Paragraph 2.5

8. Again it would assist if the main cases you are relying on for the statements here could be mentioned – preferably in a footnote. This paragraph is particularly important as it provides some of the foundation for what follows in the paper.
9. It may be appropriate in this paragraph or elsewhere to quote in full the relevant passage of Lord Templeman in *Carver v Duncan* which is as follows:

"The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and encumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate".

Tax Representation

There is nothing in this judgement that restricts the approach to the formulation put forward in paragraph 2.5. In that paragraph there is no reference to the first test which is to see if an expense is an ordinary outgoing of a recurrent nature such as those listed by Lord Templeman.

Paragraph 2.6

10. Paragraph 2.6 states that expenses that are incurred for the benefit of the whole fund (that is, both income and capital) are properly payable out of capital. This gives the impression that where an expense is not wholly attributable to the income fund it is treated as being related to the capital fund. However, in some circumstances you suggest that an apportionment may be acceptable to ascertain the part of an expense that is solely attributable to the income fund. For example in paragraphs 9.6 and 9.7 you indicate that accountancy charges for the preparation of trust accounts which include a balance sheet can be apportioned on a just and reasonable basis. It may be appropriate to mention in paragraph 2.6 that in certain circumstances an apportionment may be appropriate.

Paragraph 3.1

11. The last sentence of the first bullet point in this paragraph may be misunderstood. Some readers may think you are saying that allowable trustees' expenses are not allowable so far as the taxation of beneficiaries is concerned.

Paragraph 3.6

12. There is widespread disagreement with the view that trustees' remuneration is not an expense of the trustee. This is perhaps the point in the paper where the divergence of views should be mentioned and the reader should be told that this issue will be examined in a separate paper at a later time. We see no harm in giving HMRC's current view on the matter providing some caveat is included that it is widely disputed. If the paper fails to do so we think it would be unfair because practitioners may fail to take the action necessary to protect their clients' interests. It could also prompt professional bodies to issue warnings on the point to members to avoid actions in negligence.
13. We note that s.686 (2AA) ICTA 1988 refers to income 'applied in defraying the expenses of the trustees in that year which are properly chargeable to income.' The draft paper concludes that trustees' remuneration is not allowable because it is not an expense of the trustee. If the trust deed expressly provides for payment of trustees' remuneration it cannot be a distribution. Readers of the draft paper may well ask: if it is not an expense of the trustee what is it?

Paragraph 4.16

14. We agree that the last bullet point about the requirement for an expense to be paid in the tax year concerned appears to be in accordance with the legislation. Section 686

Tax Representation

(2AA) refers to ‘income applied in defraying the expenses of the trustees in that year....’ However, we understand that in practice an accounting or accruals basis has been accepted by HMRC in the past. The trend elsewhere in tax legislation is for profits and income to be measured in accordance with generally accepted accounting principles. If your view is that trustees’ expenses must be paid in the tax year to be allowable it may be worth dealing with the position regarding accruals for trustees’ expenses incurred but not paid.

Paragraph 5.1

15. We think that the accrued income scheme should be considered in relation to this paragraph (ss.710-728 ICTA 1988). The scheme applies to trusts and we understand that it is HMRC’s view that such income is taxed as it accrues and is subject to the rate applicable to trusts even in an IIP settlement.

Paragraph 5.12

16. The statement that TMEs should be allowed on an ‘incurred’ basis rather than when paid as regards IIP trusts will be generally welcomed. However, it highlights an anomaly in the law which should be corrected in relation to s.686 settlements. In order to provide consistency for trusts in general a statement of practice (or concession) that an accruals basis would also be acceptable for discretionary and accumulation and maintenance settlements would be helpful if in practice that is what is happening.

Paragraph 5.13

17. We welcome the clarification given in this paragraph. In effect it confirms that an income deficit can be carried forward and deducted from a future year’s income.

Section 6 – IIP Beneficiaries – Other Aspects

18. In this section the arguments are clearly set out and are helpful. However, it would be equally helpful to see a similar section on trusts subject to s.686.

Paragraph 7.3

19. This paragraph contains a clarification relating to bare trustees who hold a lien. Effectively the bare trust will be treated as an IIP trust. This will be welcomed by readers. We note that this paragraph deals with circumstances in which trustees’ remuneration is deductible. Elsewhere you have omitted from the paper discussion of trustees’ remuneration but we think that the views expressed here that trustees’ remuneration is allowable are correct in law.

Paragraph 9.4

20. The distinction between situations where an expense can be and cannot be apportioned is not clear. The examples provided of first an expense of employing a

Tax Representation

secretary to administer the trust as a whole and second the preparation of trust accounts which include a balance sheet are too close to see any real distinction. A reason should be given why the cost of employing a secretary cannot be apportioned by reference to the time spent on the income fund compared with time spent on the capital fund. The statutory or judicial authority for the distinction should also be mentioned.

Paragraphs 9.5 to 9.7

21. The accountancy costs of drawing up trust accounts will be allowable as TMEs on the basis of a just and reasonable apportionment between capital and income. We assume that an apportionment made by the preparer of the accounts would suffice but your confirmation would be appreciated. Where accountants are only instructed to prepare income accounts the full cost would appear to be allowable. Again we should be grateful for your confirmation of this point.

Paragraphs 9.8 and 9.9

22. The current Revenue practice as set out in the Trust Manual is to allow audit fees. The draft paper therefore indicates a change of practice to one of requiring an apportionment similar to that for accountancy fees. If this is correct please let us know the effective date of this change.

Paragraph 9.10

23. We would suggest that a reasonable basis for apportionment of the cost of preparing the trust tax return would be to exclude the estimated cost of preparing the capital gains tax part of the return. We would welcome your confirmation of this point.

Paragraphs 9.13 and 9.14

24. It is not clear from the draft guidance whether charges for a bank account can be apportioned in certain circumstances. If the bank account is used to collect dividends the bank charges will be for income account. However, if the account also includes occasional sums for the purchase or sale of investments the charges will relate to both income and capital. If the transaction charges relating to the capital transactions can be isolated and identified can there be an apportionment? It may, however, be impractical for bank transaction charges or account maintenance charges to be apportioned on a transaction by transaction basis by reference to whether the transaction is related to income or capital.
25. The statement about the deductibility of interest appears at odds with the words of Lord Templeman in *Carver v Duncan* quoted in paragraph 9 above. It would assist if you could reconcile his speech with the treatment described in the draft paper. In particular it would assist if you quote your authority to show how the actual use of the funds detracts from what Lord Templeman said in that case.

Tax Representation

Paragraph 9.15

26. We accept of course that depreciation is not an allowable deduction in computing trading profits. However, some accountants would argue with the bald statement that depreciation is not an expense. Whether it is an expense for the purposes of s.686 (2AA) is another matter. It might be better in this paragraph to give reasons why you think depreciation should not be regarded as representing income applied in defraying the expenses of the trustees which are properly chargeable to income.

Paragraph 9.16

27. We refer to our comments on draft paragraph 2.5. It would assist if you would also give the authority for your statements in this paragraph.

Paragraph 9.22

28. Here you make the point that interest accrued but not paid is not allowable as a trustees' expense because it is not paid in the tax year concerned as required by s.686 (2AA). Our comments above on paragraph 5.12 concerning accruals apply equally here.

Paragraphs 9.23 to 9.25

29. These paragraphs deal only with interest on overdue tax and not surcharges or penalties. It may help to add some words to deal with such liabilities. It could be argued that for the better management of a trust, trustees may incur surcharges under self assessment. On very rare occasions the same argument could be advanced in relation to penalties. Therefore, should these costs be allowable?
30. We note that interest on unpaid inheritance tax is accepted as properly chargeable to income even though it clearly relates to capital. This is in accordance with *Carver v Duncan*. However, it contrasts with draft paragraphs 9.14 and 9.21 where the treatment of interest as an expense is restricted to loans and overdrafts used for the purposes of income.

Paragraph 9.28

31. In this paragraph it would assist if some guidance could be given on the tax consequences of a distribution in kind: for example, where the trustees meet an expense which is the personal liability of a beneficiary. Is this a deemed distribution that should be accompanied by a form R185? Can the beneficiary claim repayment of the tax paid?

Tax Representation

Paragraph 9.31

32. In some large trusts there will be expenses on the maintenance of the premises and salaries of the staff which constitute ordinary outgoings of a recurrent nature as mentioned by Lord Templeman in *Carver v Duncan*. While it is accepted that the purchase of premises is a capital expense the maintenance of them is not. If such trusts purchased annual services each year from an external source of the kind carried out by their staff the trustees would regard the costs as chargeable against income. We therefore think that there is no clear authority to say that such costs are not allowable against income. At the very least office running costs of the type referred to in paragraph 9.31 would seem to be an appropriate case for an apportionment as set out in paragraph 9.4.

KM
4.8.05

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members and students, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

Tax Representation

ANNEX B

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160.