

## Trust Expenses - Income or Capital?



### IMPORTANT GUIDANCE FROM HMRC v TRUSTEES OF THE PETER CLAY DISCRETIONARY TRUST (2008)

#### A REPORT ON THE JUDGMENT OF THE COURT OF APPEAL OF ENGLAND AND WALES DELIVERED ON 19<sup>TH</sup> DECEMBER 2008

##### The Facts

A discretionary trust was established with four trustees: two were described by the family as the "non-executive" trustees, one was an "executive trustee" (an accountant), so described in contrast to the non-executive trustees, and the fourth was a family company. The non-executive trustees charged fixed fees. The executive trustee charged on a time basis. In 2000-2001 the trustees' fees were in the region of £47,000.00, of which approximately £42,000.00 was charged by the executive trustee and £5,000.00 by the non-executive trustees.

There were three investment managers of the trust, each with their own custodian company. The investment managers charged fees on a percentage rate.

The case related to whether the trustees were entitled to set any of the following against trust income<sup>1</sup>:-

1. Executive trustee fees
2. Non-executive trustee fees

3. Investment management fees
4. Custodian charges
5. Bank charges
6. Professional fees for accountancy and administration

##### The Decision

**The Special Commissioners** had held that there was no underlying principal that expenditure for the benefit of income and capital as a whole was allocable against capital alone: they thought that there was an underlying principal of fairness between the income and capital beneficiaries. Accordingly, apart from investment management fees, they thought that it was fair to allocate part of the expenses to income on the basis of fairness between the different classes of beneficiary.

**The High Court** thought that the Special Commissioners were wrong and found that the decision in *Carver v Duncan* [1985] 1 AC 1082 decided the position and was binding upon it. Consequently, the court decided that trust capital would bear the costs, expenses and charges incurred for the benefit of the whole trust estate, income and capital. The court rejected the "fairness" argument and held that the Special Commissioners had erred in law.

In the High Court proceedings, however, HMRC had accepted that, "consistently with the principle that all costs, charges and expenses incurred for the benefit for the whole estate must, necessarily, be treated as of a capital nature", it would be possible to

<sup>1</sup> In this case the allocation was of particular concern since it affected the tax liabilities - in other cases, it may be particularly important if the income and capital beneficiaries are different.

apportion bank charges, accountancy fees<sup>2</sup> and custodian fees if it would be possible to attribute part to income alone. The judge in the High Court did not look at why HMRC accepted those principles in relation to certain types of expense by comparison with the other types.

The High Court also held that the trustees were correct in allocating expenses on an accruals basis.

**The Court of Appeal** found a mid-line between the views of the other Special Commissioners and the High Court. It thought that the Special Commissioners were wrong to say that *Carver* did not lay down a general principal that expenses incurred for the benefit of the estate over a whole (income and capital) could only be set against capital. Having considered two cases, the Court of Appeal concluded that the Special Commissioners were wrong to say that *Carver* did not lay down a general principal. They held that:

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- a. expenses incurred for the benefit of capital alone were to be set against capital.
- b. expenses incurred for the benefit of income alone were to be set against income.
- c. expenses incurred for the benefit of both capital and income were to be set against capital alone.

In the first case (*In re Bennett* [1896] 1 Ch 778), expenses for an annual audit were held to be for the benefit of both life tenant and remaindermen (capital beneficiaries) since both benefited from supervision of the trustees and, whilst the funds would initially be offset against capital alone, the income beneficiary would lose the benefit of future income from the expended capital. Again, in *Carver v Duncan*, where life assurance premiums and professional investment management fees were paid, the court thought that it was fair to set them not against income but against capital, because they were incurred for the benefit of the estate as a whole. The life assurance policies would inure to the benefit not just of the capital funds but also the income funds in the sense that, when they gave rise to benefits, they would also augment the trust fund and, in turn, increase the amount of income. Similarly, annual fees paid to investment advisors were for the benefit of the estate as a whole because this affected the future value of

the trust funds and, in turn, the future level of income arising from the capital. Hence, Sir John Chadwick, in the Court of Appeal, said that,

*"it is, I think, beyond argument that an expense is incurred 'for the benefit of the whole estate' in the present context when the purpose or objects for which that expense is incurred is to confer benefits both on the income beneficiaries and on those entitled to capital on the determination of the income trust."*

He went on to say, at paragraph 29, that,

*"It is only those expenses which are incurred exclusively for the benefit of the income beneficiaries that may be charged against income."*

By the time of the hearing in the Court of Appeal, HMRC had resiled from parts of their case; they accepted that they

*"[did] not contend that the rule is all or nothing, precluding the apportionment of a single expense. But apportionment is not based upon the general principle of achieving fairness between beneficiaries. Instead it is based upon the ability to demonstrate that part of the expense relates to the trustee's due to the income beneficiaries alone. That is, if it can be shown that an identified or identifiable part of an expense is for work carried out for the benefit of the income beneficiaries alone, then that part is properly chargeable to income."*

Sir John Chadwick said that he regarded that as a correct statement of the general law.

Against that background, the Court of Appeal found that it was possible to allocate part of an expense against income in respect of the executive trustee fees, professional fees and bank charges.

There remained only two sets of expenses in dispute; the non-executive trustees' fees and the fees of the investment managers. Overruling both the Special Commissioners and the High Court, the Court of Appeal held that there was nothing in principle to prevent the non-executive trustees' fees from being allocated against income to the extent that it could be shown that their work related to income beneficiaries. The fact that they charged a fixed fee and did not charge on a time basis (unlike the executive trustee) should not preclude an

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<sup>2</sup> And, the Court of Appeal thought, other professional fees.

apportionment. However, the onus would be on the trustees to demonstrate that part of their fees ought to be offset against income. Sir John Chadwick added at paragraph 38 that,

*"it is, I think, no answer to say that, in the absence of time records, determination of that proportion will, necessarily, be imprecise: a realistic estimate can be made."*

Turning to the investment management fees, the trustees accepted that advice as to the investment of capital or of accumulated income ought to be offset against capital alone. The trustees had argued that income that the trustees had resolved to accumulate, but which they had not yet "actually" accumulated by investing it, still represented income for the purposes of the allocation of investment management expenses. This found no favour with the Court of Appeal: Sir John agreed with the High Court judge and the Special Commissioners who thought that, once the trustees had resolved to accumulate the income, the monies to be accumulated ought properly to be regarded as capital, so that the expenses incurred in connection with the investment of those monies should not be said to be chargeable to income. He added that the position might be otherwise if the trustees were temporarily investing income whilst deciding whether to accumulate it. Lloyd and Arden LJ delivered concurring judgements. Arden LJ added that the onus of showing that some of the fees of the non-executive trustees related to advice for the exclusive benefit of income beneficiaries rested on the trustees.

## Guidelines

In summary, the following rules can be stated:

- There is nothing in the nature of a trust expense (e.g. investment management, accountancy, etc.) that, of itself, determines whether it must be allocated against capital or income – the matter is determined by those beneficiaries for whose benefit that expense is incurred.

- If an expense is incurred for capital beneficiaries or for the benefit of capital and income beneficiaries, it must be allocated to capital.
- If an expense is incurred, or a part of an expense can be identified as being incurred, exclusively for income beneficiaries, it should be allocated against income. But the onus will be on the trustees (at least as regards taxation issues) to justify any allocation against income.
- Trustees will need to consider in light of the *Clay* case
  - a) how to record and allocate expenses going forward and
  - b) whether they need to re-visit the allocation of expenses in previous years.

Should you have any questions or request for more information please contact:

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