Distinguishing between capital and income for trust and tax purposes

22 DECEMBER 2008

Robert McLean
TRUST MANAGER | UK

Trustees have always had to distinguish between capital and income, for tax purposes and to protect the interests of differing classes of beneficiaries. In order to do so it is imperative to maintain clear and accurate records. What is capital and what is income?

What is capital?

For trust purposes assets that trustees receive when the trust commences, such as land and property, chattels, investments and cash are regarded as capital. So too, are proceeds derived from a sale of assets. Liabilities attaching to those assets are charges against capital. When such assets are sold, any gain or loss increases or decreases the amount of capital in the trust and any new assets acquired with the proceeds also belong to capital.

What is income?

As a general rule, regular returns arising on a capital asset may be regarded as income. For example, dividends paid by companies, interest or dividends on unit trusts and bank interest on capital deposits are treated as income, as is rent on the letting of property or chattels, and profits on trading activities.

Tax

Income Tax, which is referable to income received, is for trust purposes payable from income whilst both capital gains tax and inheritance tax, which relate to capital assets, are for trust purposes payable from capital. Interest on late payment of tax is for trust purposes charged against income (see below).

Interest

Overdraft or debit interest, together with interest payable on unpaid tax, including Inheritance Tax, is under trust law payable from income, whether or not tax relief is available. In the case of accrued interest arising on gilts and bonds, the purchase or sale price is adjusted depending on the number of days' accrued interest the bargain carries. Such accrued interest remains capital for accounting purposes and any income tax that is paid on accrued income is for trust accounting purposes payable from capital; any relief is attributable to capital, also. Trustees should ensure that the correct adjustments are applied between capital and income accounts so that different classes of beneficiaries are not disadvantaged.

De-mergers

Generally, a company that is not in liquidation can only make distributions to shareholders out of profits, i.e. by paying dividends. However, difficulties have arisen when the courts have sought to classify trust receipts from companies by way of distributions to shareholders (Bouch v Sproule (1885) and Hill v Permanent Trustee Company of New South Wales (1930) ). Broadly, de-mergers fall into two types: direct and indirect. A direct de-merger is when a company, which owns shares in another company, distributes those shares to its own shareholders; the trustees receiving those shares do so as if they were a dividend (Sinclair v Lee (1993)) and, in the case of a trust with an interest in possession, they become the property of a life tenant. This was the case when Burberry was de-merged from Great Universal Stores in December 2005. Conversely, an indirect de-merger is when a company forms a subsidiary, to which shares in another company are transferred, and the subsidiary distributes the shares to its shareholders; the shares received by the trustee shareholders are added to capital.

Scrip dividends

Rather than paying a dividend in cash, a company may offer its shareholders the choice of taking new shares in the company. Such shares are the property of the income beneficiary (re Malim (1894)). However, since the abolition of Advanced Corporation Tax on 5 April 1999, scrip dividends have generally lost their attractiveness for companies.
Enhanced scrip dividends

In the days when scrip dividends were more popular, in some cases, as an inducement for shareholders to take additional shares in a company rather than a cash dividend, a company would make the value of a share alternative higher than the cash dividend. Trustees are, of course, required to obtain the greatest benefit for the trust and, as a consequence were in some difficulty if they decided not to opt for the 'enhanced' scrip dividend. In the case of enhanced scrip dividends, the enhanced element was akin to a bonus issue of shares and, therefore, was capital in nature; only the amount equivalent to the cash dividend was income in nature. Consequently, where trustees elected to receive a dividend in the form of shares rather than in cash, any excess in the value of the shares received over the amount of the cash dividend alternative had to be treated as capital. Therefore, trustees needed to compensate an income beneficiary by paying to them the equivalent of the cash dividend not received. A reserve to satisfy income tax at the basic rate had to be made at that time. New shares taken, whether allocated to capital or to an income beneficiary, had a zero base cost so apart from entering details of the new shares on the investment schedule when they were applied to capital, there were no accounting entries to make. If the amounts involved were relatively small and the costs involved disproportionately high, trustees sometimes preferred to allocate the enhanced scrip dividend to the life tenant or to take the lower, cash alternative.

Accumulation units

"Accumulation units" in reality distribute income, which is reinvested in more units. Whilst the units received are taxed as income the units themselves are added to capital to increase the original holding. As this complicates matters for trustees in trust terms, and the amounts involved are relatively small, it is usually preferable for trustees not to invest in accumulation units. The preferable investment would be in a fund that makes no distributions but allows the capital value of the units to increase.

Minerals and gravel

If a trust document provides that the life tenant is unimpeachable of waste, one-quarter of the income should be treated as capital and the remaining three-quarters should be treated as income. However, if the trust instrument does not provide that a life tenant is unimpeachable of waste then three-quarters of the income should be treated as capital and one-quarter should be treated as income. Regardless of the trust treatment, for tax purposes one-half of royalties, rents and other such receipts derived from securing and exploiting minerals or gravel under a lease or licence are subject to income tax. UK trustees must regard one-half of the royalties as a chargeable gain and subject to capital gains tax. Of any properly allowable management expenses, only one-half may be applied against the royalties treated as income but no deductions can be made against the capital gains tax charge.

Timber

The trust treatment of income derived from the sale of timber is not dissimilar to that described above (Minerals and gravel). However, profits used to be taxed as income under Schedule B. This is no longer the case and such profits or gains from the occupation of woodland are not chargeable. Costs are not allowable for tax purposes and the accounting treatment means an unallowable loss may arise against income.

Trust management expenses

Management expenses in trust terms should be split between capital and income in proportion to the work done in relation to each. However, it is often the case in a trust that more of the annual management fees will relate to income and trustees need to treat different classes of beneficiaries fairly so as, for example, not to disadvantage a life tenant. Those expenses that are incurred in dealing with capital assets, such as those relating to the sales and purchases of shares, are deductible against capital. Expenses connected with routine maintenance (of capital assets) are allowable against income, e.g. insurance premiums. More substantial work to properties is deducted against capital as are professional fees incurred in calculating and reporting chargeable gains. Expenses related to collecting trust income, including rent, are deductible against income as are professional fees that are in respect of producing trustees’ tax returns. Investment management charges that are levied on a regular basis might be thought of as being routine and, therefore, deductible against income, but case law makes it clear that they are deductible against capital (Carver v Duncan (1985); and Bosanquet v Allan (1985)). An investment manager’s charges in relation to the acquisition or disposal of investments are deducted against capital. For tax purposes, expenses deducted against income are not allowable in respect of the trustees’ liability to basic and lower-rate income tax. However, they may be included in a calculation of a life tenant’s share of income in respect of their personal tax and the trustees’ liability to tax at the rate applicable to trusts. Investment manager’s charges on the sale of investments are an allowable deduction for capital gains tax.

In HMRC v Trustees of the Peter Clay Discretionary Trust, the trustees of a discretionary settlement made payments in respect of management expenses that related in part to capital and in part to income. The trustees claimed a deduction for tax purposes on the basis that the expenses were related to income. HMRC largely rejected the claim and the matter went to appeal before the Special Commissioners, who held that the proportion of the expenses should be charged to income but that investment management charges were ‘predominantly attributable to capital.’ Appeals were made by both sides from both sides and in the High Court Lindsay J held that the effect of Carver v Duncan was that ‘trustees’ expenditure incurred for the benefit of the whole estate ... has to be regarded as a capital expense.' He also held that the Special Commissioners were correct in treating the investment management charges as being chargeable to capital. He dismissed the HM Revenue and Customs argument that the cash basis was the correct method of allocating management expenses and held that the accruals basis was the proper way of doing so in a particular year of assessment.

Apportionments

Defining what is capital and what is income sometimes produces a lack of fairness between those beneficiaries who are entitled to capital and those who are entitled to income. As a consequence, the law intervenes (see below). Generally, apportionments are seldom carried out as they can be time consuming, costly and often the amounts involved are relatively small. Any well drafted, modern trust deed should prevent the need for apportionments but trustees of older deeds that do allow for apportionments must take care, consulting the beneficiaries to agree a fair and pragmatic way forward. The Apportionment Act, 1870 states that all periodic payments of income will be considered as accruing daily and shall, accordingly, be apportioned. This is reasonably straightforward in the case of interest and rents received but less so in relation to dividends, which are not necessarily declared for a given period until much later. On a practical level, trustees might wish to settle matters before then on the basis of a reasonable estimate provided agreement can be obtained from all the relevant parties. Dividends received after the date a life interest came
to an end, which relate to a company year that ended before that date, are not apportionable and the dividends are due to capital of the deceased life tenant’s estate. Any dividends received after the termination of a life interest that relate to a company year that commenced after the date the life interest comes to an end will be attributable to income of the trust. For income tax purposes, such income is receivable on the date it was paid by the company making the payment and the dividend is subject to tax in the trustees’ hands, although the tax relating to that applied to capital will be payable out of capital.

Apportionments are necessary when residuary funds are left in trust to pay the income to a life tenant with the capital eventually passing to remaindermen. This also applies when funds are held in trust for minor beneficiaries; trustees’ powers over income during a minority are different from their powers over capital. The death of a life tenant or when there is a change of beneficiary is another occasion when statutory appointments are carried out. The proportion of income accrued up to the date of the change is due to the original beneficiary or their estate whilst any income accruing after that date is due to the new beneficiary. For trust accounting purposes, apportioned income received is credited to the relevant capital and income accounts and should be dealt with on an arising basis to avoid problems over distribution. A strict application of the Apportionment Act leads to the complexities of rule in re Joel 1967. In this case it was decided that statutory apportionment should be carried out where there is a fund to which Trustee Act 1925, s31 applies, i.e. a fund that is held in trust for members of a class of beneficiaries contingently on their attaining a specified age, and the interest of a beneficiary changes.

Law Commission

In July 2004 the Law Commission issued a consultation paper on reform of (i) rules governing the classification of trust receipts as income or capital; (ii) the rules, both equitable and statutory, requiring conversion of the original property or apportionment between the capital and income accounts; and (iii) the impact of the rules on charities, with particular reference to permanent endowments. This was as a result of concerns raised during the passage of the (now) Trustee Act 2000. The law commission published its report: ‘Capital and Income in Trusts: Classification and Apportionment (Law com No 315) on 6 May 2009. Copies are available from www.lawcom.gov.uk/citcat.htm.
Authors

Robert McLean

TRUST MANAGER | LONDON

Private client

📞 +44 20 7597 6055

✉️ robert.mclean@withersworldwide.com