

USING FAMILY TRADING TRUSTS FOR LAND DEALS – STOPPING TAX AT THE BASIC RATE

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Introduction

If the taxpayer wants to do a land trading deal he could do it in his own name and pay 40% income tax. On the other hand if it is done by a settlement under which the settlor and the spouse of the settlor and children whilst minor are excluded from all benefit then only a charge to tax at the basic rate (20%) would apply assuming the profit as a matter of trust law in on capital account even though for tax purposes it would be a trading transaction.

The tax position is based on the case of *Carver v Duncan* (1985) STC 356. The subsequent case of *HMRC v Peter Clay* (2008) STC 928 does not affect the analysis.

How it works

The proposal is that a UK trading trust be set up which carries out a UK land trading deal. This will be a trading transaction within ITTOIA 2005 s.6(1) which charges to income tax the profits of a trade arising to a UK resident. The person liable to the tax is the person receiving or entitled to the profits (s.8).

Critically the settlor and the spouse of the settlor and the minor children of the settlor will not be capable of benefiting under the settlement whether directly or indirectly. Also critically as a matter of trust law the profit made from the trading deal must be made on trust capital account; this is vital to ensure that the trust rate of 40% under ITA 2007 s.9(1) does not become payable.

The trading trust is one under which an individual has an interest in possession. The individual could be a child of the settlor who is an adult. In the alternative there could be a number of persons with interests in possession.

When the 40% Rate Applies

The rules dealing with the application of the trust rate to income are contained in ITA 2007 s.479 et seq. The rules apply to trusts where income is to be accumulated or which is to be paid out in the discretion of the trustees or any other person (ITA 2007 s.480(1)). The question is what is income for the purposes of these provisions? After all if a large land trading gain is made, it may be argued that because the gain is on trust capital account it can be accumulated and furthermore it can be paid out by the trustees on the exercise of a power of appointment over capital.

The conclusion to be drawn from the legislation is income means income for trust law purposes.

Firstly, this is because the section refers to income to be accumulated or paid out in the discretion of trustees. This is indicative of trusts where income such as dividends arise to the trustees who then accumulate or pay the same out.

Secondly, there is to be deducted from the income in determining the trust rate the expenses of the trustees so far as they are properly chargeable to income ignoring any express terms of the settlement. Once again this indicates that one is looking to trust law to determine the expenses of the trustees which are properly deductible from the income receipts of the trust.

Thirdly, there are a number of headings in s.482 which specifically provide that gains which are very likely to be gains of a trust capital nature are to be charged at the trust rate. For example Type 1 in section 482 will be a share buyback which under trust law would be a capital transaction.

Finally in the case of *Carver v Duncan* 59 TC 125 the House of Lords had to decide whether payments to upkeep a capital insurance policy could be deducted from the income of a settlement for income tax purposes. The trust deed specifically allowed the deduction. It was held that only income type deductions determined under trust law would be deducted from the income which it was accepted was determined under trust law. Lord Templeman at 194h stated, the legislation:-

“...imposed an additional rate of income tax on the income of accumulation and discretionary settlements remaining after the deduction of expenses “properly chargeable to income tax (or would be so chargeable but for any express provisions of the trust)”, the section appears to me to allow the deduction of income expenses and to prevent the deduction of expenses which are only chargeable to income as a result of an express provision of the trust.”

Thus if an accretion to trust capital is made, this is not the type of income envisaged by the legislation even though for tax purposes such an accretion to capital may be chargeable to income tax as comprising a profit of a trade arising to a UK resident within ITTOIA 2005 s.6(1).

The consequence of the trust rate not being applicable is the only rate exigible is that under ITA 2007 s.11(1) ie the basic rate of charge.

Anti-Avoidance Provisions

Under ITTOIA 2005 s.619 et seq, if income arises to the trustees of a settlement, that income shall be treated for all the purposes of the Income Tax Acts as the income of the settlor and of the settlor alone if during the life of the settlor the income arises from property in which the settlor has an interest (ITTOIA 2005 s.619 and s.624). ITTOIA 2005 s.625 states that a settlor is treated as having an interest in property if there are any circumstances in which the property is payable to the settlor or the settlor’s spouse or civil partner or is applicable for the benefit of the settlor or the settlor’s spouse or civil partner or the same will or may become so payable or applicable.

There is no problem in the settlor being a trustee of the settlement. He cannot however benefit from the same and for good measure he should bear all his own expenses and he must not take any trustee remuneration.

It is appreciated that it is not sufficient just to exclude the settlor from benefit. One must ensure that nothing is applied for his benefit.

If for example the settlor lends money to the settlement this would offend the legislation because the repayment of the loan would be a benefit.

If the trustees borrowed money and the settlor provided back to back security for this, then this would offend the legislation because the release of the security would be a benefit (*IRC v Wachtel* 46 TC 543). There can of course be an outright settlement of funds.

Inheritance Tax

The settlement although drafted as an interest in possession trust will for all inheritance tax purposes be treated as a discretionary trust. The settlor and spouse of the settlor would be excluded from all benefit for the purposes of the reservation of benefit provisions. Thus if there is a gift of property into settlement after the 7 year period the gifted amounts would cease to be within the estate for all relevant purposes of the settlor. The settlor could use up his £312,000 nil rate band or what is left of it. If needs be the spouse of the settlor could put further monies in. These would become “time-discretionary trusts”. The principle here is if the trust is brought to an end before the 10 year anniversary then the funds appointed out would only bear a nil rate of IHT. The relevant provision is IHTA 1984 s.68. The legislation envisages an IHT transfer which is equal to the value of the property in the settlement when it commenced and there is an assumption that that amount of property was transferred by the transferor or transferors cumulating in any other transfers which they may have made within the period of 7 years ending on the date the settlement commenced. See s.68(4)(a) and (b) and (5)(a) and (c). The result is all the funds for example could come out to the life tenants before the first 10 year anniversary without any charges to inheritance tax.

Note also, although the life tenants have interest in possession, no charges to IHT will arise on the death of any of the beneficiaries.

One could review the position near the 10 year anniversary to determine whether funds could be appointed out to the beneficiaries or indeed left in the discretionary trust bearing the 10 year anniversary charge which could never be more than 6% of the net value of the fund at the time of the anniversary charge.

Income From Investment

Note that if the project proves successful and the trustees invest the trust capital or if otherwise normal income arises to the trust then this income such as dividend income or bank interest must be paid to the life tenants after the trustees have taken out their expenses if any (the trustee expenses will not reduce the trustee income tax charges on that income). The trustees will be liable for the basic rate of tax. The life tenants may be liable to tax at the higher rate of tax (ITA 2007 s.10(3)).

Capital Gains Tax

TCGA 1992 s.4(1A)(1A) states that the rate of capital gains tax in respect of gains accruing to the trustees of a settlement in a year of assessment shall be equivalent to the rate which for that year is the rate applicable to trusts (now the trust rate). TCGA 1992 s.77 states that any gains

made by the trustees of a settlement shall be treated as accruing to the settlor if the following can benefit under the settlement: the settlor, the spouse of the settlor or the civil partner of the settlor or the minor children of the settlor. Considering the rate at which trusts pay capital gains tax this section is not of particularly great significance, nevertheless the settlor and the spouse of the settlor and a civil partner of a settlor and the minor children of the settlor are excluded from all benefit under the settlement.

Other Taxes

Other taxes may be relevant depending on all the circumstances. The trustees may have to register for VAT. The trustees may have to bear stamp duty land tax in an appropriate case.

Conclusion

The trading trust is an attractive proposition. The price to be paid for this is the settlor and his spouse or his civil partner and his minor children cannot benefit from the settlement.

