Trusts: cashflow conundrum

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***P.C.B. 146** *In this highly topical article Anna Gaston, who is counsel at the law firm Maurice Turnor Gardner LLP, looks at cashflow challenges for trustees and beneficiaries in times of crisis.*

It is probably fair to say that the last two years have brought problems for the UK and its economy not seen in a generation. With the spectre of Brexit still looming, the Covid-19 outbreak has brought unprecedented economic challenges and social restrictions. It remains unclear what the long-term social and economic ramifications will be, but during the next few weeks and months many individuals and businesses will struggle and cashflow might be a significant concern. Unfortunately, not everyone will be able to benefit from the Chancellor’s largesse and so in this article we consider other potential sources.

Giving is good

Accepting a gift from a family member may seem like the best solution for many in these circumstances, but there remain a number of issues to be considered before any money changes hands. Gifts between family members can be a source of future tension—for example where one party believes there has been a gift and others consider it to have been a loan. This can cause real difficulty if the recipient of the funds later divorces, as parents are often loath to see an ex-son or daughter-in-law walk away with potentially half of the cash given.

Clear paperwork setting out the terms of any loan or gift can prevent misunderstandings and aim to protect the different parties’ interests and set out clear intentions. Although families can be reluctant to enter into formal legal documents, having one document which has been agreed, signed and dated by both parties can help reduce problems in the future. In particular, as a minimum it is important to set out: the amount of the payment; whether it is made as a gift or a loan; if a loan, whether, and if so how, interest is to be charged; when repayment is due and how repayment is to be made (for example repayment could be paid in sterling on the sale of the house the loan was used to finance). If the loan is to a married family member it will be important to consider if the loan is to the family member or to the couple jointly. Ideally this document would be signed before any money changes hands, but it is possible for the parties to vary an existing loan or to record the terms of the loan after it has been made. It is always possible for the lender to agree to waive or release the loan if that is appropriate in the future, but a gift cannot be turned into a loan after the event. ***P.C.B. 147***

Turn to a trustee

Beneficiaries may find that their actual cash needs increase over the next few months (for example those who are looking to buy new property may need additional funding for rent if purchases are delayed). Beneficiaries in this position will need to consider whether to request assistance by way of a loan or a distribution from trust.

Beneficiaries of trusts looking for more support from their trustees might consider requesting loans or distributions from the trust, or requests for the trustees to consider making investments in a beneficiary’s business. Trustees will be faced with difficult choices as they must ensure that they act in the best interests of all of their beneficiaries, and must react swiftly to protect both their beneficiaries, and the trust fund. Trustees should, as a matter of course, be in reasonably regular contact with their beneficiaries and should have an understanding of each beneficiary’s funding needs. However, in difficult times such as these, trustees may need to undertake some further consultation with the beneficiaries as things can change quickly. Depending on the outcome of those discussions, the trustees may need to weigh up the competing needs of the various beneficiaries, and whether the trust fund can accommodate all of those needs.

It can be very difficult to assess the competing needs of a class of beneficiaries, and trustees might need investment advice, particularly if they are considering making changes to the underlying investments to generate more income for the income beneficiaries. If any such changes are contemplated, the trustees will need to continue to consider the needs of any capital beneficiaries and the potential long-term impact on the value of the trust fund for future beneficiaries. The trustees should keep careful records of their investigations and deliberations, and where relevant pass trustee resolutions to record their decision. While trustees are not (in general) required to give beneficiaries information relating to their decision-making process, the more detailed the trustee minutes and resolutions are, the better prepared a trustee may be to answer any future challenge to his decisions.

Those who are fortunate enough to have (but perhaps not yet need) the safety net of a trust fund may also look to their trustees to increase charitable giving for those whose personal circumstances are not so secure, or who are working to protect others during this difficult time. Many trust deeds include charity as a potential object, in which case trustees will be able to comply with any requests from beneficiaries. Where a trust deed does not include an express power to pay trust assets to charities, there are some options open to the trustee. Trustees of English law trusts will have slightly more limited options than say, a trustee of a Jersey law trust, but it is still possible for trustees to make a payment to charity at the request of a beneficiary. Where the charity in question is not an object of the trust, the trustees may, of course, distribute funds directly to a beneficiary who may make an onward gift to charity—though this may not be a desirable course of action for tax purposes and the trustees will still need to be satisfied that the payment is for the benefit of that beneficiary.

Trustees may also make a payment directly to charity where the beneficiary has, or considers himself to have, a moral obligation to make a charitable payment and he would otherwise feel compelled to make a donation out of his own funds.[1] The amount of any funds paid out to a charity will depend on all of the circumstances at hand and trustees should be careful to ensure that they are acting within the scope of their powers at all times.

Taxing times

Trustees of non-UK resident trusts and beneficiaries now also need to consider the impact of the "onwards gifts" rules which apply where a UK resident individual (the recipient) receives funds by way of a gift from a non-UK resident individual (or a remittance basis taxpayer) (the donor) if those funds originated from a trust. The onwards gifts rules apply where a capital payment (the original payment) is received by ***P.C.B. 148** a beneficiary from the trustees of a settlement, and at the time of receipt there was an arrangement or an intention in relation to the direct or indirect passing on of the payment and it was reasonable to expect that the whole or part of the original payment would be passed on to a UK resident individual.[2] The rules apply even if the donor did not himself receive the assets directly from the trustees.

"Example 1

If the trustees of a non-UK trust pay £100 to A, who is resident in Switzerland, and A later makes a gift to B, also resident in Switzerland, and B then makes a gift of £100 to his UK resident son C, the new rules will treat (and tax) C as having received the £100 directly from the trustees."

The scope of these rules is very broad, and advice should be taken by individuals or trustees to make sure that the tax consequences of any payment are fully understood by the recipient.

If a non-UK resident beneficiary of a trust (A) regularly receives distributions from a trust, and he regularly makes gifts to his three children (B, C and D), these rules could cause serious difficulties if D is or becomes UK resident.

"Example 2

A receives a capital payment from the trust in April 2020, which he uses to buy a painting. In May 2021 A sells the painting and uses the proceeds to buy a car, which he gives to B in December 2021. In February 2023 B sells the car, and gives one-third of the proceeds of sale to C and one-third to D. D may then find that he is taxed as if he had received the cash gift directly from the trust, and not from B. This payment may then be matched to untaxed gains in the trust gains pool, such that D has a tax liability and a reporting obligation to HMRC. This is the case notwithstanding that D was unaware that the funds had originated from the trust."

In Example 2 D might be able to claim that the legislation does not "bite" because there were no arrangements in relation to the passing on of the funds, or that neither A nor the trustees had the requisite intention to pass on the funds. The legislation provides a rebuttable presumption that where the onwards gift is made within three years of the original payment, the intention element is met. It may, therefore, be difficult for D to prove to HMRC that A did not have any intention to pass on the funds to D, particularly if A has a pattern of receiving distributions from the trust which he then passes on to his children. Ultimately, UK resident recipients of gifts from non-UK residents or remittance basis taxpayers must take reasonable steps to understand the original source of those funds.

Direct distributions

Appointments of funds by trustees from a trust rather than a gift from a family member can help alleviate some tensions—as there are more likely to be formal discussions and a clear record of the terms of any payment made and certainty as to the tax consequences for the parties. However, trustees may face difficulties if there are some beneficiaries who make greater demands than others. This dissipation of funds may be to the detriment of the trust fund and to the remaining beneficiaries. One solution may be effectively to "split" the trust fund if one beneficiary would like to be "paid out". However, this brings its own potential risks if the value of the remaining fund changes dramatically. Trustees will need to maintain a difficult balance between their beneficiaries and bearing in mind that a trust fund should be a safety net for all beneficiaries in difficult times. ***P.C.B. 149***

Cautious credit

Trustees being asked to make a loan to a beneficiary need to give this careful consideration in order to be confident that it is a genuine loan and not a distribution in disguise. Unless a beneficiary is able to claim a credit for tax already paid by the trustees the tax consequences for the beneficiary can be extremely unwelcome if HMRC assesses the payment as an outright distribution and not a loan. Trustees therefore need to ask a number of questions of themselves and of the beneficiaries before committing to make the payment. For example, has trust fund cash already been advanced by way of loan previously, and if so, how much and how many times? Have these been repaid or are they secured in some way? Do the trustees understand the purpose of the loan and the prospects and timescale for repayment? Should the loan be made by the trustees directly, or by an underlying company?

Where trustees agree to make loans to beneficiaries it is very important that the terms are known and understood by all parties and that those terms are recorded. It is not necessary, legally, for a loan agreement to be prepared: the terms of any such loan can be recorded by a trustee resolution or by an exchange of emails, but in practice a formal loan agreement can be invaluable to the parties at the time the loan is made if this brings issues to the fore that the parties may not otherwise have thought about, for example the immediate tax consequences of the loan, and also can prevent misunderstandings or mistakes arising in the future if the terms were always clearly recorded in a loan agreement.

In particular, in April 2017, Sch.A1 to the Inheritance Tax Act 1984 (Sch.A1) has introduced new rules relating to the taxation of certain loans, or of personal guarantees made in relation to loans where the funds were used to purchase, maintain or enhance a UK residential property interest. and certain other residential property expenses (for example rent payments).[3] Individuals and trustees can fall foul of these rules and accidentally create an exposure to UK inheritance tax in relation to assets which would otherwise be "excluded property". For example, a non-UK resident trustee who is asked to make a loan to a UK resident beneficiary may be used to the concept that loans he makes to a UK resident beneficiary are "excluded property" provided that the loan is structured as a specialty debt, or if the loan is in fact made by an underlying company rather than the trustee directly. The effect of Sch.A1 is to deny excluded property status to assets whose value derives, directly or indirectly, from a UK residential property interest. Therefore, it will be particularly important for trustees to understand how any loaned funds will be used by a beneficiary, as the trustees will need to be able to keep track of and identify any "property-related loans" as these may be taxed differently on 10-year anniversaries of the trust or on other taxable events.

Benefiting a business

Beneficiaries may also be experiencing significant economic difficulties in relation to their businesses and may turn to trustees for financing options to help shore up the company for the next few months. This can raise some difficult issues for trustees in terms of assessing the relative strength of the business, whether the investment is a "good" investment and whether making it would be in the interests of the trust and beneficiaries as a whole. As such, the trustees should deliberate whether any payment of funds should be considered purely for the benefit of that beneficiary and therefore structured as a personal loan. Where business loans are made, trustees will need to judge whether a rate of interest should be applied and, if so, what would be commercial in the circumstances. This is a particular risk if an "excluded person" (such as a settlor) is also interested in that business as the trustees will need to take care to ensure that there is no incidental benefit to that excluded person. ***P.C.B. 150***

Problematic powers

Certain trust deeds include a power which expressly permits a third party (such as a protector) or a beneficiary to direct the trustees to make certain investments, or to give, or withhold, consent to certain payments out of trust. Under normal circumstances these powers can act as a useful check and balance between the family and the trustees. During times of crises, however, complying with requirements of these powers can add unhelpful delays, if for example, the protector or power holder is not easily contactable, and decisions need to be made quickly. Access to the courts may not be easy at the moment, so this may not be a good solution for trustees who are faced with uncontactable or unco-operative protectors. Trustees may therefore need to consider whether there are any pre-emptive steps that they can take to ensure that they are able to react quickly should an urgent request be made during these next few weeks. For example, trustees might need to check that they have the best contact details for protector or power holder, and check that they have all necessary "KYC" documents. Trustees may want to update the protector on any important developments and on the immediate plans, so that the protector is aware of any possible upcoming requests and can ask for any information they think they might need in advance.

In some cases it may be necessary for trustees to take more drastic measures, for example to consider amending the terms of a trust to achieve a temporary release of a power holder's powers during any period of absence or incapacity or after a certain time period if the protector is not responsive. In the event that a protector is not contactable due to illness there may be provision under the trust deed to forgo the need for a protector's consent during that time, or the trust deed might require a new protector to be added in place of the incapacitated protector. If a new protector is required, this may again cause significant time delays as the incumbent protector's capacity must be assessed and a new protector identified and appointed. It is therefore well worth the trustees' time in reviewing the terms of the trust deed to determine what, if any, contingency plans can be put in place to ensure the trustees can be responsive to their beneficiaries' needs.

Where trustees are corresponding with beneficiaries and protectors in advance, they should bear in mind that a trustee cannot fetter his discretion—trustees should therefore be careful not to appear to make a final decision before they have formally done so, and they must always remember that if the facts change they must not blindly adhere to an earlier "in principle" decision, but they must continue to consider all of the relevant facts and circumstances as they arise.

Trustees will have many difficult decisions to make over the next few weeks, but rainy days such as these are precisely why dynastic and family trusts can be a helpful family tool.

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Footnotes

1 *In Re Clore's Settlement Trusts [1966] 1 W.L.R. 955; [1966] 2 All E.R. 272.*

2 Taxation of Chargeable Gains Act 1992 ss.87I -87K.

3 M. Herbert, "New Rules on Deemed Domicile and Foreign-Owned residential Property" [2017] P.C.B. 49, 53–56.