Wealth and trusts quarterly digest

February 2017

Welcome to the February 2017 edition of our wealth and trusts quarterly digest. The digest provides up to date commentary and analysis on key sector developments. Our tax, wealth and trusts teams are able to provide a wide ranging service to assist you and your clients in responding to market trends and legal developments. We would welcome the opportunity to discuss any concerns you may have and always welcome feedback on the content of our publications.

Feature

When can trustees exercise their right of retention?

Trustees generally incur personal liability when carrying out their functions as trustees. This liability might arise through contractual liabilities to third parties, claims against them by beneficiaries, or indemnities given to previous trustees. Trustees may continue to be liable following retirement (or winding up of the trust) unless arrangements are made to the contrary. more›

News

Foreign Account Tax Compliance Act (FACTA) and the new Common Reporting Standard

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The British Virgin Islands (BVI) has released specific guidance notes relating to the requirements of the Common Reporting Standards (CRS) as it is to be implemented in the BVI. The guidelines provide some much needed clarity and direction on the specifics of the interpretation of the CRS in the BVI. more›

EU Directive to expand UK's "persons with significant control" disclosure regime

In a fundamental shift in the UK's disclosure regime and overall approach to corporate transparency, since 30 June 2016, UK companies have been required to collect and retain information on those who ultimately own and control them and to file that information on a central register of beneficial ownership (the PSC Regime). more›

Any comments or queries?

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The Small Charitable Donations and Childcare Payments Act 2017 received Royal Assent on 16 January 2017. more›

Case reports

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When can trustees exercise their right of retention?

Trustees generally incur personal liability when carrying out their functions as trustees. This liability might arise through contractual liabilities to third parties, claims against them by beneficiaries, or indemnities given to previous trustees. Trustees may continue to be liable following retirement (or winding up of the trust) unless arrangements are made to the contrary.

Trustees are protected against this significant liability by the statutory indemnity that is contained in section 31(1), Trustee Act 2000. Trustees are generally entitled to be indemnified out of the trust property in respect of liabilities, costs and expenses properly incurred in connection with the performance of their duties and the exercise of their powers and discretion as trustees.

In certain circumstances, trustees may consider seeking separate contractual indemnities from beneficiaries. Although the comfort offered by such indemnities will of course depend on the ability of the counterparty to satisfy any claim. Where beneficiaries do not have the necessary assets an indemnity might not be a viable option.

Exercise of the trustee's indemnity rights is supported by a number of ancillary rights. In this article we focus on the right to retain trust assets.

When is retention appropriate?

A trustee's right of retention, which is ancillary to his rights under section 31(1), arises under the general law and is available subject to the terms of the relevant trust deed. The right of retention is intended to prevent the trustee being left unprotected once the trust fund has been transferred. Accordingly, it is mostly used where other options, such as an indemnity from beneficiaries, or specialist insurance is unsuitable or unavailable.

A trustee may retain trust assets, or income, until both present liabilities and contingent, or future, liabilities for which they might become accountable have been met. In calculating any liability, the onus is on the trustee to act reasonably and ensure the retention can be properly justified. The trustee should make reasonable inquiries as to the contingent or future liabilities (and the extent of the potential liability) at the time the right of retention is relied upon. In doing so the trustee is entitled to assume the worst case outcome but must be able to demonstrate that the underlying risk is "more than fanciful".

Retention is generally only appropriate where the value of the liability is known and such liabilities can include tax and professional fees of other advisors as well as administration costs, even if these have not yet been quantified.

It is possible for trustees to retain all of the trust's assets although this will only be appropriate in the most extreme cases. By way of example, the English Court has permitted total retention where a trust faced unlimited liability for cleaning contaminated land[1].

Importantly, a beneficiary is unable to compel a transfer of the trust assets to a new trustee until the existing trustee's proper demands have been met.

1. *Environmental Protection Act 1990 (X v A and others)* [2000] 1 All ER 490.

It is important to note that it is not appropriate for trustees to retain trust assets against outstanding fees or costs. In doing so a trustee could be exposed to the risk of an adverse costs order (against them personally) should the dispute end up in Court and their conduct held to be unreasonable.

Retention and disputes

The ability to retain trust assets applies, in principle, to all liabilities trustees might face. This includes claims against trustees by third parties.

In these circumstances trustees may seek to retain assets equal to the estimated prospective costs of defending the claim, as they might become entitled to take their costs out of the trust fund. If it becomes apparent the retained funds are no longer needed they should be distributed.

If the beneficiaries dispute the amount proposed to be retained (or the necessity of the retention at all) they, or the trustees, may ask the Court to determine the matter.

The English Court (in a case concerning a breach of trust claim) suggested that a trustee should be cautious about making a retention that directly withholds funds from the beneficiaries. Further, the trustee should balance the right of retention against the beneficiaries' needs[2]. In balancing those competing elements, the Court considered the following:

- whether the beneficiary would continue with her claim against the trustee
- whether the beneficiary was likely to fail in that claim
- the beneficiary's financial resources and financial needs (the beneficiary and her husband were almost entirely dependent on the income portion of the trust)
- the beneficiary's state of health and life expectancy
- what sums of money the trustee would spend in related proceedings in the US and
- whether the court would allow the trustee's costs to be set against the income of the trust fund as opposed to the capital.

The trustee's application to allow the retention from trust income was refused in this case.

The right of trustees to exercise the right of retention remains a key principle of trust law. However, trustees should be careful to ensure that any proposed retention of trust assets does not discriminate against a class of beneficiaries as retaining assets in a manner that places the burden disproportionately, or entirely, on one class of beneficiary could lead to difficulties for the trustees if later challenged.

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2. *Close Brothers (Switzerland) SA v Ramos de Vildosola* [2008] EWHC 1267 (Ch).

News

Foreign Account Tax Compliance Act (FACTA) and the new Common Reporting Standard

Many advisors will have clients who are both UK and non-UK resident who have an interest in assets which are located abroad. These clients are set to be affected by the introduction of the Common Reporting Standard (CRS) and they, alongside their advisors, should be aware of the impact of the CRS and its interaction with the Foreign Account Tax Compliance Act (FATCA).

The CRS is effectively a regime which facilitates the sharing of information relating to taxable finances between different regulatory authorities in separate legal jurisdictions. It was published and produced by the Organisation for Economic Co-operation and Development in July 2014, and in excess of 100 jurisdictions have already signed up to the CRS.

The CRS is comparable to FATCA, as both regimes primarily aim to prevent tax evasion, commonly conducted through the use of non-domestic financial institutions and offshore investment instruments. Both systems also involve the automatic exchange of information, provide due diligence requirements, stipulate reporting obligations and use similar terminology. Indeed, advisors may be under the impression that due to the regulations in force under FATCA (and the fact that the US has not signed up to the CRS) American financial entities will not be affected by this system. It is important to recognise that this is not necessarily the case and subtle and important differences in the regimes should be noted.

Circumstances may arise in which an entity (for example, a charity, or non-profit organisation) is considered to be a non-financial foreign entity under FATCA, but a financial institution under the CRS. Similarly, there are certain institutions that may be considered to be non-financial under the CRS, but financial organisations under FATCA.

Those affected will require assistance to ensure that a particular entity is correctly categorised for the purposes of both the CRS and FACTA.

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BVI releases guidance notes on CRS requirements

The British Virgin Islands (BVI) has released guidance notes relating to the requirements of the Common Reporting Standards (CRS) as it is to be implemented in the BVI. The guidelines provide some much needed clarity and direction on the specifics of the interpretation of the CRS in the BVI.

The guidance notes confirm that:

- the initial notification to the International Tax Authority (ITA) must be made by all Reporting Financial Institutions by 30 April 2017
- all annual reporting will be made via the BVI Financial Account Reporting System (BVIFARS) (this is the same online portal that the ITA has been using to receive reporting in relation to the UK Crown Dependencies and Overseas Territories International Tax Compliance Regulations (UKCDOT) and FATCA)
- financial institutions should not need to repeat the due diligence process each time a country completes an exchange agreement with the BVI, as there is no requirement for

Financial Institutions to check whether their jurisdiction has entered into an automatic exchange relationship with the BVI
- the agreement that the BVI has signed with the UK for the automatic exchange of information (UK CDOT) will continue alongside CRS for 2017 but will be phased out in 2018 and thereafter all reporting must be conducted in accordance with the CRS
- where there is any overlap between UK CDOT and CRS, there is no requirement for duplicate reporting. However, there are some accounts which will be reportable under UK CDOT but which will not yet need to be reported under CRS (and vice versa)
- the CRS will replace reporting requirements under the repealed EU Savings Directive (EUSD) which ceased to operate after 31 December 2016. The only exception to this is the reporting of any unsatisfied obligations relating to dates before the last reporting year of the EUSD
- the filing of nil returns is not mandatory. However, Reporting Financial Institutions with no reportable accounts must still complete the notification requirement via BVIFARS.

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EU Directive to expand UK's "persons with significant control" disclosure regime

In a fundamental shift in the UK's disclosure regime and overall approach to corporate transparency, since 30 June 2016, UK companies have been required to collect and retain information on those who ultimately own and control them and to file that information on a central register of beneficial ownership (the PSC Regime).

The PSC Regime represents an early adoption by the UK of the EU commitment to transparency of beneficial ownership as set out in the Fourth Money Laundering Directive (the Directive). Such reforms have been in the legislative pipeline from as early as 2012, when the Financial Action Task Force recommended that countries should take measures to prevent the use of companies and other legal entities for money laundering, or the financing of terrorist activities. However, the Directive is wider in scope than the current PSC Regime, and potentially captures types of legal entities not covered by the PSC Regime. Accordingly, entities which have so far escaped the PSC Regime could soon face similar beneficial ownership disclosure obligations.

As the UK will remain a full member of the EU until exit negotiations are concluded, the government is still under an obligation to implement and apply the Directive. The deadline for full implementation by the UK is 26 June 2017.

Changes proposed by the Directive

The Department for Business, Energy & Industrial Strategy (BEIS) has published a discussion paper examining which UK entities it considers will fall within the scope of the Directive and will be required to disclose beneficial ownership information on a central register. UK incorporated entities which are not already covered by domestic PSC legislation but which BEIS considers to be within the scope of the Directive are as follows:

- European Co-Operative Societies
- Investment Companies with Variable Capital (ICVCs)
- Open Ended Investment Companies (OEICs)
- Scottish Partnerships and Scottish Limited Partnerships and
- certain unregistered companies.

The BEIS discussion paper goes on to outline the UK incorporated entities which it considers to be outside the scope of the Directive, which include:

- non-departmental public bodies not already covered by PSC legislation
- corporations sole (ie a legal entity consisting of a single ("sole") incorporated office, occupied by a single ("sole") natural person
- Further Education Corporations and Sixth Form Corporations and
- Higher Education Corporations, and Royal Chartered Incorporated Universities and University Colleges.

The BEIS also lists the UK arrangements and unincorporated entities which do not have legal personality and which it considers to be outside the scope of the Directive:

- Overseas companies (as the Directive clearly applies to entities incorporated within a Member State)
- Royal Chartered bodies which are re-domiciled
- Partnerships and Limited Partnerships in England, Wales and Northern Ireland (but not Scotland) and
- Unincorporated Associations.

Implementation

The UK government has confirmed that it will use the responses to the BEIS discussion paper to inform the draft regulations necessary to transpose the Directive. While these regulations are yet to be confirmed, the government has stated that its intention is to introduce similar requirements to the new entities that it considers will need to be brought within the scope of the Directive once implemented, and that the existing "landscape" of registers is already consistent with the Directive's requirements.

All laws, regulations and administrative provisions necessary to comply with the Directive must be brought into force by 26 June 2017.

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Charities legislation receives Royal Assent

The Small Charitable Donations and Childcare Payments Act 2017 received Royal Assent on 16 January 2017.

The new Act, which comes into force on 6 April 2017, makes a number of amendments to the legislation which underpins the Gift Aid Small Donations Scheme (GASDS), which was introduced in April 2013. The purpose of these changes is to simplify the GASDS and extend access to smaller and newer charities.

Under current legislation, Gift Aid charities are entitled to claim 25p tax on each £1 they receive from individual donations, which represents repayment of the basic rate tax that donors have paid on this part of their income. However, charities are only able to do this with a Gift Aid declaration from the donor testifying that they have paid at least an equivalent amount (or more) in tax in that year. While this may be relatively straightforward for donations made online (with many charities using a simple "tick box" system), there are circumstances, for example, when collecting small cash gifts in a collecting tin, where charities may find it difficult to obtain a declaration from donors. The GASDS allows charities to claim a top-up payment on donations equivalent to Gift Aid in such circumstances.

Impact of the reforms coming into force on 6 April 2017

HMRC has estimated that the measures to simplify GASDS "could benefit up to 71,000 charities that currently claim Gift Aid" and, overall, the changes are anticipated to decrease receipts by approximately £15m per annum. Broadly, the reforms:

- simplify the compliance criteria for "eligible charities" making claims under GASDS by:
  - removing the requirement that the charity must have been established for at least a two year "start-up period". This will extend the availability of GASDS claims to newer charities
  - removing the requirement that the charity must have had a good recent "track record" of making Gift Aid claims (which was previously defined as having made Gift Aid claims in at least two consecutive tax years out of the previous four tax years). This will also extend the availability of GASDS claims to more newly-established charities
- broaden the scope of the forms that the charitable donations can take to include contactless payments. Previously, only gifts made in cash qualified for top-up payments under GASDS and
- relax the community building rules.

These reforms should lead to a wider variety of charities being eligible to make claims under GASDS.

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Case reports

RS & ORS v JC & ORS (unreported) – variation of settlement

The claimants were the trustees of two family discretionary settlements and the defendants were the adult children of the settlors, the settlors themselves and the Attorney General representing charity interests. The claimant trustees applied for the variation of two discretionary settlements. The second defendant applied for an order that she be permitted to represent unborn and unascertained persons who might become objects of the discretionary settlements.

The settlements had provided for an accumulation period of 21 years and this period was near expiry. The objects clause of the settlements were widely drawn and the capital and income were substantial.

The trustees wanted to extend the accumulation period and the trust period until 2141 and to give greater flexibility to the trustees in respect of the payment of expenses. The Attorney General did not consent or object to the application and the other defendants supported the application.

Held

The High Court granted the application.

The proposed extension of the accumulation period was held to be to the benefit of the second defendant and those that she represented because it would enable the trustees to preserve capital. Furthermore, the extension of the trust period was beneficial overall because it allowed a more efficient way to pass on any family wealth to future generations.

The addition of a clause allowing the trustees to pay expenses out of capital or income was to the benefit of the second defendant and those that she represented because it made clear the degree of flexibility that the trustees had as a result of the extension of the power to accumulate and had the potential to avoid future litigation.

The court also concluded that any conflict of interest between the second defendant and those she represented was theoretical rather than actual and a representation order was appropriate.

Comment

This case demonstrates that in certain circumstances it is possible for trustees to extend the accumulation and the trust period to give greater flexibility in respect of the payment of expenses.

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Dickinson v NAL Realisations (Staffordshire) Ltd [2017] EWHC 28 (Ch) – directors' duties

The High Court considered whether the directors of a company in liquidation were in breach of their fiduciary duties. It also considered whether they were required to give priority to the interests of creditors, because at the time of entering into a transaction there was a risk that adverse events might lead to liabilities which could lead to insolvency.

The claimant was the managing director of Norton Aluminium Ltd which operated a smelting factory. The company went into administration in August 2012 following the circulation of a draft judgment in which a claim in nuisance was upheld against it. The claimant brought the instant claim to recover in the liquidation various sums totalling £1m which he claimed were due to him and secured by a debenture over the company's assets.

The liquidators brought a number of counterclaims against the claimant and the other directors of the company. The counterclaims alleged that the debenture was part of series of transactions that took place prior to the administration of the company which formed part of a scheme by the claimant to restructure the affairs of the company when it was threatened with the nuisance litigation with the object that the claimants in the nuisance litigation would receive nothing if they were successful. The scheme included:

- a transfer of the company's factory premises to the claimant in 2005 (the Factory Sale)
- a share buy-back whereby the company bought back most of the shares from the claimant and various connected parties for £2.5m (the Share Buy-Back). Most of the purchase price was paid but the outstanding amount was purportedly paid for by way of a secured debenture (the Debenture) and
- the sale by the company of a subsidiary, Norse Coatings Limited, to the claimant for £1 (the Subsidiary Share Sale).

The liquidators argued that, in effecting these transactions, the claimant had been in breach of his fiduciary duty to consider the interests of the company's creditors and that the Share Buy-Back and the Subsidiary Share Sale were transactions at an undervalue designed to put assets beyond the reach of its creditors contrary to section 423, Insolvency Act 1986, or alternatively, that the transactions were voidable as there had been no proper authorisation.

Held

In the view of the Court there was no indication that the company derived any benefit from the Factory Sale and there was no evidence that the company needed to sell the factory in order to realise funds. There was no evidence a valuation had been obtained and the sale price was less than 40% of the book value. The transaction was held to be void because of a breach of the claimant's fiduciary duty and as a consequence he was found to have held the property on trust for the company throughout the relevant period and was liable to restore it to the company and to pay compensation equal to the amount of rent received in relation to the factory.

As for the Share Buy-Back, the Court noted that the only valid way to execute it would have been in accordance with Part 18, Companies Act 2006. The claimant argued that the partial payment in cash and the outstanding Debenture were collectively the payment. NAL Realisations argued that payment could only be interpreted as payment in money. The Court was of the view that the Debenture was not sufficient. It was noted that where the consideration payable under a sale transaction was not actually satisfied at the time, a debt automatically arose, but this form of debt was not sufficient. Due to the lack of proper authority, the Share Buy-Back was void. The Share Buy-Back was also caught by section 423, Insolvency Act 1986 (transactions defrauding creditors). The claimant's sole purpose in entering into the Share Buy-Back was to reduce the net asset value of the company and ensure that his debts ranked higher than those of the claimants in the nuisance litigation. When it became apparent that the company would in all likelihood become liable in that litigation the Share Buy-Back was executed to put assets beyond the claimant in that litigation.

The Court also considered whether the Share Buy-Back amounted to a breach of fiduciary duty by the claimant. The process of the Share Buy-Back and the payment of the £2.5m at the time had not placed the company on the verge of insolvency in 2010. It had been trading and had had sufficient capital. The Court confirmed that a recognised risk of adverse events did not mean that directors were required to give priority to the interests of creditors. The mere fact there was the nuisance litigation and it could lead to insolvency did not justify a finding of a breach of fiduciary duty by the claimant. It was, however, part of the bigger picture to move assets out of the company and was therefore void.

The shares had been sold for the nominal sum of £1 whereas the joint expert valued the shares at £214,000. They had therefore been sold at an undervalue. The claimant was therefore required to either return the shares or pay an amount equal to their true value at the date of purchase.

Comment

This judgment confirms that there is no general duty on directors requiring them to give priority to the interests of creditors simply because at the time of entering into a transaction there is a risk that adverse events may lead to a liability that could result in insolvency.

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The Crown and Cushion Hotel (Chipping Norton) Ltd v HMRC [2016] UKFTT 765 (TC) – sponsorship of family member tax deductible

The Crown and Cushion Hotel (Chipping Norton) Limited (the company) operated a family owned hotel business comprising of six hotels. Mr Fraser established the business in the 1980s and was the company secretary. Throughout the relevant period, Mr Fraser was the driving force behind the business and ran the business on a day-to-day basis, notwithstanding that the company is owned by his two daughters, one of whom, Mrs Powell, is also the sole director of the company.

In 2008, Mr Fraser put an agreement in place between the company and Miss Alice Powell, his granddaughter and the daughter of Mrs Powell, under which the company would sponsor Miss Powell, who was a young racing driver who had begun to attract substantial media attention, in return for Miss Powell undertaking various promotional and advertising activities in relation to the company's business.

HMRC conducted enquiries into the company's corporation tax returns for the accounting periods ended 31 March 2011 and 31 March 2012. In June 2014, HMRC issued closure notices in respect of its enquiries and amended the returns. HMRC claimed additional corporation tax for the above periods in the sum of £155,355.17, on the basis that the company was not entitled to a corporation tax deduction in computing the profits of its trade in relation to the motor racing sponsorship payments, as such expenditure had not been incurred "wholly and exclusively" for the purposes of its trade, as required by section 54, Corporation Tax Act 2009. HMRC was of the view that the expenditure had a dual purpose of both advertising the hotel business and advancing Miss Powell's racing driving career.

The company appealed against the amendments.

Held

In allowing the company's appeal, the First-tier Tribunal (Tax Chamber) confirmed that the "wholly and exclusively" issue has to be determined by ascertaining the object of the taxpayer in incurring the expense, which is a question of fact. In making that factual assessment, the FTT has to observe a number of principles established by relevant case law and summarised by *Millet LJ in Vodafone Cellular v Shaw* [1997] STC 734 as follows:

- the words "for the purposes of the trade"' mean "to serve the purposes of the trade". They do not mean "for the benefit of the taxpayer"
- to ascertain whether the payment was made for the purposes of the taxpayer's trade it was necessary to discover the taxpayer's object in making the payment. Save in obvious cases which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment
- the object of the taxpayer in making the payment must be distinguished from the effect of the payment. A payment may be made exclusively for the purposes of the trade even though it also secures a private benefit. This will be the case if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment
- although the taxpayer's subjective intentions are determinative, these are not limited to the conscious motives which were in his mind at the time of the payment. Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made and
- the question does not involve an inquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary inquiry is to ascertain what was the particular object of the taxpayer in making the payment in issue. Once that has been ascertained, its characterisation as a trade or private purpose is a matter for the court to determine.

HMRC argued that the payments made by the company to Miss Powell were not "wholly and exclusively for the purposes of its trade". They were of a personal nature, arising out of natural love and affection for a close family member.

The tribunal disagreed with HMRC and found in favour of the company. The tribunal commented that Mr Fraser's sole object in the company making the payments to Miss Powell was to benefit the company by attracting customers to the hotels, which were situated near Silverstone race track. He was not motivated by a desire to further Miss Powell's racing career and any benefit to Miss Powell was merely an incidental effect of the sponsorship payments.

Comment

Whether an expense has been incurred "wholly and exclusively" for the purposes of a taxpayer's trade will depend on the individual facts of the case under consideration, but this decision demonstrates that it is possible for businesses to make sponsorship payments to family members and for such payments to be tax deductible provided that any benefit to the family member was an "incidental effect" of the sponsorship payment.

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