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RETIREMENT CARE GROUP LTD

v

THE COMMISSIONERS FOR HM REVENUE & CUSTOMS

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The Special Commissioners of Income Tax
John Clark

Hearing: 31 January 2007

Judgment: 26 March 2007

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Income tax; service charge moneys held on trust under s42 Landlord and Tenant Act 1987; interest thereon; whether 'income to be accumulated' within s686 ICTA 1988 and liable at rate applicable to trusts

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The appellant (RCG) oversees the maintenance of approximately 170 blocks of flats, for which it charges a fee to the tenants of each estate, as well as recovering the cost of so doing. At the end of the financial year, RCG draws up a statement of account comparing the budgeted spend in the previous year with the actual spend. Any deficit is collected from the lessees. As part of the accounting process, RCG compares all income received with all expenditure paid out. Income received comprises the sum of the service charge, the interest earned on the total of the service charge deposit fund balance (net of any bank charges incurred), and guest room income (where relevant). The interest earned on the service charge fund balance throughout the year must be disclosed to the leaseholders at the end of the year. Any interest earned can only be credited to the appropriate service charge fund and cannot be diverted for any other purpose.

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HMRC sought to tax the income from the deposits of service charges as income to which *s686 Income and Corporation Tax Act (ICTA) 1988* applied, being 'income which is to be accumulated' within *s686(2)(a)*, and therefore chargeable at the higher rate applicable to trusts. RCG denied that this was the case, relating the concept of accumulation to the legislation and cases dealing with restrictions on the ability of trustees to accumulate trust income. The service charges were subject to the statutory trust imposed by *s42 Landlord and Tenant Act (LTA) 1987*, which applied to any income as it arose. The word 'accumulate' connoted building up or collecting and adding together. Here there was no question of the income being 'added to' the principal amount paid as service charges so as to apply the statutory trust to it: the statutory trusts applied to the income expressly as such income arose. The *section 42* trust was a trust for the benefit of the current tenants at any given time. There was no postponement of the vesting of income. There was no accumulation of income in the sense used in *s686 ICTA 1988*. There was no addition of income to capital. HMRC contended that the phrase 'is to be accumulated' in *s686(2)(a) ICTA 1988* ought to be construed in a more general way, not limited by the legislation imposing those restrictions.

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Held

RCG's income from the money held on trust under *s42 LTA 1987* was subject to income tax under *s686 ICTA 1988* (para [28]). It was clear from the evidence that in the majority of cases (if not always) the income and the service charges became a single fund. Further, there was no suggestion that when the fund was applied for the purposes of carrying out maintenance or repairs, this represented a payment of income to the tenants. There was a clear policy reason for treating the income on a similar basis to the service charges. The intention of *s42 LTA 1987* was to protect tenants from the risk of the landlord taking the funds and using them for other purposes. This applied equally to the income derived from the service charges. The process of acquiring and holding the income amounted to the addition of that income to the corpus of the fund. There was no intention to provide anything by way of income to any person for whose benefit the funds were to be utilised. Addition of the income to the corpus of the fund amounted to accumulation (para [19]).

If it was correct that income becoming part of the overall trust fund held pursuant to *s42 LTA 1987* was to be regarded as accumulated, this would bring that income within the scope of *s686(2)(a) ICTA 1988*. There was no basis for excluding the accumulation of income in *s42 LTA 1987* trusts from the application of *s686*. In *s686(2)(a)* a general description of the type of income falling within the section was set out – ie, either income to be accumulated or income payable at the discretion of the trustees. *Sections 686(2)(b)-(c)* provide exceptions to the charge. The exceptions in *s686(2)(c)* were specific, relating to charitable trusts and to income on investments etc held for the purposes of certain pension schemes. The inference to be drawn from this was that subject to these specific exceptions, the intention behind the section was that any trust income 'which is to be accumulated' was to be treated as within the charge and therefore liable to tax at the rate applicable to trusts (para [24]).

Cases referred to

Re Earl of Berkeley [1968] Ch 744
IRC v Berrill [1981] 1 WLR 1449
MacNiven v Westmoreland Investments Ltd [2001] UKHL 6
Pearson & ors v IRC [1980] STC 318
Roome v Edwards [1981] STC 96
Ex p Spath Holme Ltd [2001] 2 AC 349

Statutes referred to

Accumulation Act 1800 [the *Thellusson Act*]
Commonhold and Leasehold Reform Act 2002
Finance Act 2006
Income and Corporation Taxes Act 1988, s686, Pt XV
Landlord and Tenant Act 1987, s42
Law of Property Act 1925, s164
Perpetuities and Accumulations Act 1964, s13
Taxes Management Act 1970, ss8A, 9A, 28ZA

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A DECISION

THE SPECIAL COMMISSIONER:

[1] The issue in this case arises from a joint referral, under s28ZA of the *Taxes Management Act (TMA) 1970*, in relation to certain tax returns submitted by the appellant (RCG) to the respondents (HMRC). The question is whether income which has arisen from trust funds held by RCG pursuant to s42 of the *Landlord and Tenant Act (LTA) 1987* is taxable under s686 of the *Income and Corporation Taxes Act (ICTA) 1988*.

C The law

[2] For the relevant years, s42 LTA 1987 provided:

(1) This section applies where the tenants of two or more dwellings may be required under the terms of their leases to contribute to the same costs by the payment of service charges; and in this section:

- “the contributing tenants” means those tenants;
- “the payee” means the landlord or other person to whom any such charges are payable by those tenants under the terms of their leases;
- “relevant service charges” means any such charges;
- “service charge” has the meaning given by section 18(1) of the 1985 Act, except that it does not include a service charge payable by the tenant of a dwelling the rent of which is registered under Part IV of the Rent Act 1977, unless the amount registered is, in pursuance of section 71(4) of that Act, entered as a variable amount;
- “tenant” does not include a tenant of an exempt landlord; and
- “trust fund” means the fund, or (as the case may be) any of the funds, mentioned in subsection (2) below.

(2) Any sums paid to the payee by the contributing tenants by way of relevant service charges, and any investments representing those sums, shall (together with any income accruing thereon) be held by the payee either as a single fund or, if he thinks fit, in two or more separate funds.

(3) The payee shall hold any trust fund:

- (a) on trust to defray costs incurred in connection with the matters for which the relevant service charges were payable (whether incurred by himself or by any other person), and
- (b) subject to that, on trust for the persons who are the contributing tenants for the time being.

- (4) Subject to subsections (6) to (8), the contributing tenants shall be treated as entitled by virtue of subsection (3)(b) to such shares in the residue of any such fund as are proportionate to their respective liabilities to pay relevant service charges. A
- (5) If the Secretary of State by order so provides, any sums standing to the credit of any trust fund may, instead of being invested in any other manner authorised by law, be invested in such manner as may be specified in the order; and any such order may contain such incidental, supplemental or transitional provisions as the Secretary of State considers appropriate in connection with the order. B
- (6) On the termination of the lease of the contributing tenant the tenant shall not be entitled to any part of any trust fund, and (except where subsection (7) applies) any part of any such fund which is attributable to relevant service charges paid under the lease shall accordingly continue to be held on the trusts referred to in subsection (3). C
- (7) If after the termination of any such lease there are no longer any contributing tenants, any trust fund shall be dissolved as at the date of the termination of the lease, and any assets comprised in the fund immediately before its dissolution shall: D
- (a) if the payee is the landlord, be retained by him for his own use and benefit, and
- (b) in any other case, be transferred to the landlord by the payee. E
- (8) Subsections (4), (6) and (7) shall have effect in relation to a contributing tenant subject to any express terms of his lease which relate to the distribution, either before or (as the case may be) at the termination of the lease, of amounts attributable to relevant service charges paid under its terms (whether the lease was granted before or after the commencement of this section). F
- (9) Subject to subsection (8), the provisions of this section shall prevail over the terms of any express or implied trust created by a lease so far as inconsistent with those provisions, other than an express trust so created before the commencement of this section. G
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This section has since been amended by the *Commonhold and Leasehold Reform Act 2002*, but the changes took effect after the years covered by the referral under s28ZA TMA 1970.

[3] For the relevant years, s686 ICTA 1988 was in the following form:

- A ‘(1) So far as income arising to trustees is income to which this section applies it shall be chargeable to income tax at the rate applicable in accordance with subsection (1AA) below, instead of at the basic rate or, in accordance with section 1A, at the lower rate or the Schedule F ordinary rate.
- B (1AA) The rate applicable in accordance with this subsection is:
- C (a) in the case of so much of any income to which this section applies as is Schedule F type income, the Schedule F trust rate; and
(b) in the case of any other income to which this section applies, the rate applicable to trusts.
- D (1A) In relation to any year of assessment for which income tax is charged:
- (a) the Schedule F trust rate shall be 25 per cent, and
(b) the rate applicable to trusts shall be 34 per cent,
- or, in either case, such other rate as Parliament may determine.
- E [...]
- F (2) This section applies to income arising to trustees in any year of assessment so far as it:
- G (a) is income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it); and
(b) is not, before being distributed, either:
- (i) the income of any person other than the trustees, or
(ii) treated for any of the purposes of the Income Tax Acts as the income of a settlor; and
- H (c) is not income arising under a trust established for charitable purposes only or, subject to subsection (6A) below, income from investments, deposits or other property held:
- (i) for the purposes of a fund or scheme established for the sole purpose of providing relevant benefits within the meaning of section 612; or
(ii) for the purposes of a personal pension scheme (within the meaning of section 630) which makes provision only for benefits such as are mentioned in section 633.’

Subsection (6A) relates to property investment LLPs and is not relevant to RCG.

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The facts

[4] The evidence consisted of a statement of agreed facts and issues, and a bundle of documents. There was no oral evidence. The statement was broadly as follows:

1. RCG has a business of offering services to oversee the maintenance of approximately 170 blocks of flats, for which it charges a fee to the tenants of each estate, as well as recovering the costs of so doing. In some cases, but not all, RCG is also the landlord of the estate. Its own fee income and profits are reported in its annual audited accounts which form the basis of its own tax return form (CT600) and are not the subject of this reference. B
 2. RCG collects moneys from the tenants of each block, having set a budget for the expenditure expected to be incurred thereon during the years, and reports via annual income and expenditure accounts to the tenants on the expenditure actually spent, collecting any deficit as appropriate. C
 3. The budget set for each block includes annual contributions towards expenditure expected to be incurred in relation to the maintenance and repair of those premises, and the funds are placed on deposit in the meantime, earning interest. D
 4. The interest credited by the bank on the service charge fund deposits has been subject to basic rate tax-withholding at source, apart from that arising in 1999/2000. RCG has paid basic rate tax by self-assessment in respect of that year. E
 5. The service charge expenditure procedure is as follows. Lessees establish their quarterly payment procedures and amounts so that RCG receives once a quarter (on 1 April, 1 July, 1 September and 1 January) the agreed amount, comprising an individual lessee's proper portion of the service charge contributions on their estate. The relevant RCG property manager tasked with overseeing the maintenance of a given estate, with the assistance of third-party building surveyors, if required, organises the relevant maintenance or repair project. Payment is made to the third-party contractors from the service charge fund held by RCG. F
 6. At the end of the financial year RCG draws up a statement of account, audited by independent accountants, comparing the budgeted spend in the previous year with the actual spend. Any deficit is collected from the lessees. As part of the accounting process, RCG compares all income received with all expenditure paid out. Income received comprises the sum total of the service charge, interest earned on the total of the service charge fund deposit fund balance (net of any bank charges incurred), and guest room income (where relevant). G
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- A 7. The interest earned on the service charge fund balance throughout the year must be disclosed to the leaseholders at the end of the year. Any interest earned can only be credited to the appropriate service charge fund and cannot be diverted for any other purpose.
- B 8. It is not disputed that RCG acts separately as trustee for each block of flats. However, for practical reasons, the agent acting for RCG submitted a single trust and estate return encompassing all the interest credited during the year, together with a supporting schedule identifying the relevant amount for each estate for each fiscal year.
- C 9. Enquiries opened by HMRC under *s9A TMA 1970* are in progress in relation to four trust and estate returns submitted by RCG in respect of the years ended 5 April 2000, 2001, 2002 and 2004.
- D 10. The issue for determination is whether *s686 ICTA 1988* is applicable to RCG as trustee of funds held by it subject to the trusts imposed by *s42 LTA 1987*.

[5] From the other documentation, I find the following facts. Budgeting for the expenditure is arrived at on the basis of a projection for the sinking fund. An example was included in the bundle; the period covered was five years. The projection indicated the desirable retained balance, and set out various items of expenditure, showing the anticipated expenditure in each year, the projected contributions from tenants, and the closing balance for each year. A column also showed the expected future expenditure projected for the future after the five-year period. The example compared the effect of contributions remaining at a constant level with that of contributions increased from year to year by a standard amount.

[6] There is an approved code of practice for private retirement housing. The bundle contained the 2005 version, which did not apply for the relevant years. The bundle also contained the previous (undated) version, which stated at para 2.2:

- G ‘Where the landlord is not a registered housing association, managers must ensure that all contributions to variable service charges, including reserve funds, are held in accordance with the trusts established under S.42 of the Landlord and Tenant Act 1987.’

- H The 2005 version contains the same statement at para 2.2, and other statements relating to the investment of such funds which are in broadly similar terms to the wording of the earlier version. These relate to the obligation to keep service charge payments separate from the landlord’s and the manager’s own money, and to the investment of those payments. Chapter 4 of both versions sets out the manager’s responsibilities for repairs and maintenance, in broadly similar terms. The obligation to consult is contained in Chapter 10 of the earlier version and Chapter 11 of the 2005 version, also in broadly similar terms.

[7] Specimen leases were included in the bundle. Taking the first as an example, the recitals referred to RCG's specialist knowledge and expertise in the management and maintenance of sheltered housing, and to its agreement to manage and maintain the estate on the landlord's behalf in accordance with the latter's covenants. The obligation on the tenant to pay the service charge to RCG on the landlord's behalf was specified in a schedule to the lease. This also obliged the landlord, as soon as convenient after each accounting period, to provide a certified account to the tenant showing the expenses and outgoings, as well as provisions made for future expenditure. The landlord was obliged to set the service charge at a level which was fair and reasonable in the circumstances so as to ensure as far as reasonably foreseeable that the service charge would not fluctuate unduly from year to year.

[8] The lease provided at para 1(iv) of the third schedule:

'If in relation to any accounting period the Service Charge payable by the Tenant shall be greater than the Provisional Service Charge payment made by the Tenant for that period (apportioned where necessary) then the difference shall be paid by the Tenant to the Landlord on demand and if in relation to any accounting period the Service Charge payable by the Tenant shall be less than the Provisional Service Charge payments made by the Tenant for that period (apportioned where necessary) then the difference shall at the option of the Landlord be refunded by the Landlord to the Tenant or credited against a payment due for the next period.'

[9] After a continuing exchange of correspondence with HMRC, beginning in 2003, on the treatment of interest on funds held for residential service charges, on 18 June 2004 UHY Hacker Young wrote to HMRC's London trust district enclosing four trust returns reporting the receipt of interest. On 5 July 2004 J Meghani, a Revenue Officer, wrote to RCG. He said that unless any indication to the contrary was given within 30 days, it would be assumed that RCG wished the returns to be treated as if they were in response to a notice under s8A TMA 1970.

[10] By three letters dated 15 July 2005, HMRC Trusts Truro Office notified RCG of enquiries into the years ending 5 April 2000, 2001 and 2002. By a letter dated 27 September 2004, HMRC IR Trusts London Office notified UHY Hacker Young of a notice of enquiry sent to RCG under s9A TMA 1970 in respect of the year 2002/03 (in a letter dated 4 March 2006, HMRC Trusts Truro notified UHY Hacker Young that RCG's tax return for 2004/05 had been processed without any revision).

[11] The reference under s28ZA TMA 1970 is in the course of the above enquiries relating to 1999/2000, 2000/01, 2001/02 and 2002/03.

Arguments for RCG

[12] Mr Sherry summarised HMRC's case. This was that income arising on the deposits of service charges was income to which s686 ICTA 1988 applied and was therefore chargeable at the rate applicable to trusts. HMRC argued that such income fell within s686(2)(a), being 'income which is to be accumulated'. RCG, as trustee, did

A not agree. Thus the short question was whether such income was 'income which is to be accumulated'. In support of RCG's contention to the contrary, Mr Sherry made the following points:

B 1. Accumulation was a concept of trust law relating to remoteness of vesting, and described the process whereby the vesting of the right to income was postponed during the period permitted by law, under s164 of the *Law of Property Act 1925* or pursuant to s13 of the *Perpetuities and Accumulations Act 1964*.

C 2. Accumulation typically described the process whereby income was not merely retained but was retained in a manner so as to cause its character to change, typically becoming capital and so subject to the trusts of capital. He referred to the comments of Harman LJ in *Re Earl of Berkeley* [1968] Ch 744 at p772E-G:

D 'Accumulation to my mind involves the addition of income to capital, thus increasing the estate in favour of those entitled to capital and against the interests of those entitled to income. The mere retention of income on the *In re Coller* principle does not alter its nature: it remains income and will be paid out to the income beneficiaries when no longer required to secure the annuitants' rights. It seems to me to be analogous to money retained against liabilities for repairs or covenants in leases; and in *Vine v Raleigh* I find an instance of this.'

E 3. The statutory trust imposed by s42 LTA 1987 applied to any income as it arose. The word 'accumulate' connoted building up or collecting and adding together. Here, however, there was no question of the income being 'added to' the principal amount paid as service charges so as to apply the statutory trust to it: the statutory trusts applied to the income expressly as such income arose. It was simply not apt to describe income which was impressed with a statutory purpose trust when it arose as being 'income which is to be accumulated'. The words 'to be accumulated' denoted a process which was to happen to the income. Yet the statutory trusts did not allow any room for such a process; they were binding on RCG as trustee as the income arose.

F 4. Sections 42(6)-(8) LTA 1987, concerning the position after the termination of a lease, operated in a similar way to the regime for a members' club. The section 42 trust was a trust for the benefit of the tenants for the time being. There was no postponement of the vesting of income. There was no accumulation of income in the sense used in s686 ICTA 1988. There was no addition of income to capital. The trustees had no discretion as to how to deal with the income.

H 5. The statutory context of s686 was that it fell within Pt XV of ICTA 1988 dealing with settlements. It fell within Ch 1C of that Part, dealing with 'Liability of Trustees'. The interpretation of s686(2)(a) should take the context into account: Pt

XV was concerned with settlements, and the word 'accumulation' had a particular and well-understood meaning in that context. There were no authorities on the meaning of 'discretion'. Mr Sherry submitted that in the context this must mean a power or trust to choose between those persons to whom payment could be made, rather than a discretion in relation to such matters as investment, since otherwise all forms of trust would fall within this description. The principle and approach to be taken in relation to statutory construction had been set out by Lord Nicholls in *Ex p Spath Holme Ltd* [2001] 2 AC 349 at p396.

6. Accumulation described the process whereby the right to income was postponed. It was added to capital, so favouring those entitled in remainder, as opposed to those entitled to income.
7. Mr Sherry emphasised that *s42 LTA 1987* applied to each estate separately. This followed from the definition of 'payee' in *s42(1)*. Despite this, he explained that there had been an agreed arrangement for RCG to make a single composite return (the strict position was that the reference did not concern RCG, which acted as a manager, but instead related to each of the entities which in its capacity as landlord was a trustee in respect of the service charges). If there was doubt as to the proper construction of *s686 ICTA 1988*, this should be resolved in favour of the taxpayer.
8. HMRC had asserted without explanation that in relation to trusts under *s42 LTA 1987* there was an implied power to accumulate. However, in a booklet issued by the Department of the Environment and entitled 'The Management of Flats - The Rights and Duties of Landlords', it had been stated:

'Generally speaking, the additional rate tax will be chargeable if the trustee has power, whether stated specifically or implied by the lease, Trust Deed or other document, to accumulate income or to distribute it in accordance with his or her discretion or that of any other person.'
9. Mr Sherry submitted that where the lease was cast in contractual terms and did not contain any trust at all, the writer of that advice thought that the rate applicable to trusts would not apply.
10. In its published Revenue Interpretation (RI) 197 and the later replacement RI 218, HMRC had given no explanation of the basis for the references to an implied power of accumulation. RI 218 referred to 'contributions to certain variable service charge funds (and to sinking funds)'. Both categories fell within *s42 LTA 1987*, as indicated by the paragraph headed 'Funds created'.
11. If HMRC were right in relation to accumulations, tenants in a larger block or with a larger fund would find themselves suffering the rate applicable to trusts on

- A deposit income, whereas those in smaller blocks or newer premises would or might not. This was a strange side effect; it might inform the interpretation of *s686*.
12. In *Re Berkeley*, the question had been whether the retention of income of residue by way of security for the annuitants was an accumulation. This affected the respective positions of the income beneficiaries and those entitled to capital. In the present case the statutory trust, so far as it applied to income, applied in exactly the same way as it did to the service charge payments. There was no addition of income to capital: as income accrued, the statutory trusts applied to it immediately. *Section 42(3) LTA 1987* set out the terms of the trust, but the application of the fund in discharge of service charge items was all for the benefit of the tenants for the time being.
13. The word 'accumulation' in cases was sometimes used loosely to refer to retention of income. Mr Sherry submitted that the proper meaning (as derived from the *Thellusson Act* [the *Accumulations Act 1800*]) should be given to the words used in *s686*, having regard to their context. In *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6 at paras 32-35 Lord Hoffmann had distinguished between the use of terms with a strict or a commercial meaning. In *Roome v Edwards* [1981] STC 96 at p100 Lord Wilberforce had referred to being informed as to the general background. It had to be determined from the context whether a word was being used in its ordinary sense or with a technical meaning. Here it was clear from the context that the word 'accumulated' was referring to the trust concept of accumulation. Mr Sherry cited *Theobald on Wills* (15th ed) at p633; the Law Commission's Report on Perpetuities and Accumulations; Megarry and Wade, *The Law of Real Property* (6th ed) paras 7-152 and 7-176; and *Woodfall on Landlord and Tenant* at para 7.204, which referred to the service charge moneys (held under a statutory purpose trust) belonging to the tenants beneficially and being held on trust to provide services. He argued that retention of income together with capital for the purposes of satisfying a liability was not an accumulation.
14. In reply to Mr Ewart's points, Mr Sherry questioned the expectation that *s686 ICTA 1988* should cover the whole range of types of trusts. It might well be limited to private trusts alone. The present trust was a statutory one to apply funds for a particular purpose; it was a non-charitable 'purpose trust', so it would not be at all surprising to find it falling outside the scope of *s686*. *Section 42(3) LTA 1987* dealt with the whole fund, which could be contrasted with a family settlement with trusts over capital and income. There was no direction in *s42* that income should be added to the service charges. There was a single purpose trust; this did not connote the addition of one element to the other.
15. Under *s42(2)* it would be open to a landlord to hold income in a separate fund. Mr Ewart had argued that this was not significant. However, he appeared to be

- saying that if the trust was held as a single fund, it would be accumulating. On this basis, Mr Sherry argued that if income were kept in a separate trust, there would be no accumulation within *s686*. A
16. Mr Ewart had cited *Widgery LJ in Re Berkeley* at p780. Mr Sherry submitted that the comments should not be taken out of their context, which was dealing with the *Thellusson Act* and the old perpetuities rule and considering the question of the remoteness of vesting. *Section 42(3)* was declaring an immediate and binding purpose; there was no postponement of the purpose. The terms were not precluding persons from receiving income, which was the context to which accumulation was relevant. There was no space for an implied trust to accumulate. Further, it was an express trust to spend the money; this was inconsistent with the whole idea of accumulation. There was no postponement of entitlement to capital combined with an entitlement to income. If there had been, there might be some question of accumulation. B
17. There was nothing of the nature of a discretion in *s42(3)(a) LTA 1987*: there was an immediate mandatory trust. Discretions as to choice of builders and similar matters were not relevant to this question, which concerned the existence of a fiduciary discretion. C
18. *Section 686* had its origin in the investment income surcharge. The reason for the survival of the trust provision was that where there were long-term accumulations of income in a fund otherwise taxable at basic rate, the higher-rate tax which would in other circumstances have been payable would be avoided and compounded. It was for this reason that *s686* was all of a piece with the settlements legislation: it was dealing with non-fragmentation of income. *Section 42 LTA 1987* was very distant from that: it involved a statutory trust, it had some elements of purpose, and had nothing to do with rolling up and compounding income. D
19. Mr Ewart had referred to the application of the fund for the benefit of the landlord. This was understandable in a remote sense, but in a much more immediate sense the trusts 'bit' on service charges paid by a tenant under a lease. This all related to the discharge of the tenant's obligation. It was the purpose of the statutory trusts grafted onto that obligation. As stated in *Woodfall on Landlord and Tenant*, this was to protect the tenants from the landlord's insolvency or the landlord retaining the income. The trusts were in a very immediate sense for the benefit of the tenants, and the trust law benefits were that the funds did not become mixed with those of the landlord. E
20. The provision for the return of surpluses to tenants on a yearly basis was all of a piece with their interests being immediate vested interests. In turn, this was inconsistent with the whole idea of accumulation. F
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- A 21. The referred question should be answered to the effect that the income was not 'income which is to be accumulated' and so was not within *s686 ICTA 1988* and was not subject to tax at the rate applicable to trusts for the years ended 5 April 2000, 2001, 2002 and 2003.

B **Arguments for HMRC**

[13] Mr Ewart confirmed that there was no dispute in relation to the facts. The issue was a short point of construction involving two provisions – *s686 ICTA 1988* and *s42 LTA 1987*. The question was whether *s686* applied to income held under *s42*. He made the following points:

- C 1. There was no doubt that RCG was a trustee in relation to the service charge funds which it held on the trusts imposed by *s42 LTA 1987*. The income arising to it was 'to be accumulated' in the sense that it was to be added to the capital of the fund before being spent (*Re Berkeley* at p772E-F, 780C-D). Under the trust imposed by *s42*, the income which was received by the trustee could be dealt with in exactly the same way as the capital from which the income arose. This was an accumulation for the purposes of *s686(2)(a)*.
- D 2. The question did not involve construing the *Thellusson Act*. There could be something which was an accumulation but did not amount to an accumulation for the purposes of the *Perpetuities and Accumulations Act 1964*. He cited *Theobald on Wills* at p633, which referred to 'accumulation' for the purposes of the rule against accumulations, and also referred to accumulation of property directed to be applied to certain purposes at once, which was not within that legislation. In the same way, the Law Commission had referred (at para 9.2 of its Report on The Law of Trusts) to the meaning of the word 'accumulation' as being 'for the purposes of the rule' – ie, against excessive accumulations of income.
- E 3. The purpose behind *s686* was different from that behind the *Thellusson Act*. Mr Ewart referred to the different forms of trust. The purpose of *s686* was to deal with trusts with no interest in possession: if *s686* were not applied, such a trust would only be liable to basic rate tax. Originally *s686* had imposed an additional rate, but it now applied a single rate, which had varied over the years.
- F 4. The aim of *s686* was to identify particular types of trust, in order to apply what was appropriately called the 'rate applicable to trusts'. Mr Ewart submitted that the cases on the *Thellusson Act* should not be ignored, but that they should be recognised as dealing with a different provision.
- G 5. On the construction of *s686*, *s686(2)(b)* showed that it was not dealing with interest in possession trusts or cases where the income was deemed to be that of the settlor. *Section 686(2)(a)* had two limbs. The first was 'income to be accumulated'. A mere power to accumulate would not bring income within this.
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- The more common form with a power and a trust to accumulate would be within *s686(2)(a)* – this was talking about the payment as income. The third type of trust contained a power to accumulate but provided that subject to that power, the income was that of a beneficiary. An example was *Pearson & ors v IRC* [1980] STC 318. In *IRC v Berrill* [1981] 1 WLR 1449, Vinelott J had held that the income of a trust of this type was within the predecessor of *s686*. HMRC submitted that the income of the *s42* trust fell within this first limb of *s686*.
6. *LTA 1987 ss42(2)-(3)* was important in establishing the type of trust. The phrase in *s42(2)* ‘together with any income accruing thereon’ gave a statutory direction that any income was to be held in the trust fund on the same trusts as the service charges. The effect was to create one set of trusts, and not two separately over capital and income. This was a contrast with family settlements or private trusts, where there were trusts for income, and trusts for capital. Private trusts might be discretionary, and could involve different beneficiaries for income and capital respectively. This should be borne in mind when looking at the cases cited: references to repairs, maintenance and improvements were relevant where trusts for income and capital were separate.
7. The cases were not relevant to *section 42* trusts. These involved accumulation under the statutory provision: there was a single fund under the trust. There was an aggregation of income to form one single fund, as described by Widgery LJ in *Re Berkeley* at p780D. His reference to accumulation ‘for a period’ indicated that he was considering the *Thellusson Act*. Similarly, Harman LJ at p772E-F was discussing a family settlement. Widgery LJ was looking at a higher level of generality.
8. In the present case the trust was not a family settlement. In Mr Ewart’s submission, it could not be right to say that there could be no accumulation where income and capital were held under the same trusts. This was not a case of locking up income in favour of capital beneficiaries for excessive periods of time.
9. The decisions relating to the use of income to pay expenses concerned circumstances where there were separate capital and income interests. The dichotomy in question was between expenditure for an income purpose and expenditure for a capital purpose. If it was the latter, accumulation was necessarily involved. It followed that the cases were not authority for the proposition that payment for repairs etc could not amount to an accumulation.
10. Under *s686(2)*, the income arising in the present case was ‘income to be accumulated’: it arose by virtue of *s42 LTA 1987*, and was automatically to be added to the fund. Repairs were paid for out of the whole of the fund. The service charges were not income.

- A 11. As a secondary argument, if the primary submission were not accepted and it was held that the income was not 'income to be accumulated', the income was 'payable at the discretion of' RCG as trustee. They could decide how the money was to be spent, whom to employ, and what maintenance should be carried out. They had a discretion over payment; this was not a question of investment, but of payment. The income did not belong as it arose, or at any time, to anyone in the position of a life tenant. RCG had the power, within the terms of the *section 42* trust, to apply the income at its discretion. This also brought the income within *s686*, under the second limb of *s686(2)(a)*.
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- C 12. The expenditure did not relate to repairs on a trust property. The repairs did not enure entirely for the benefit of the tenants, but they did affect the landlord's reversion.
- D 13. The referred question should be answered by determining that the income which arose to RCG from the money held on *section 42* trusts was subject to income tax under *s686 ICTA 1988*.

Discussion and conclusions

E [14] Although this appeal is based on the assumption that RCG is the trustee, the strict position is that there is a separate trust (and therefore a separate trustee) in respect of each property, and in a number of cases RCG is a manager rather than a trustee. For the purposes of this reference, I will follow the parties' approach and treat RCG as if it were a single trustee in relation to all the properties. The decision on the combined reference will then apply to the respective trustees for each property involved.

F [15] Mr Sherry's approach on behalf of RCG is to relate the concept of accumulation to the legislation and cases dealing with restrictions on the ability of trustees to accumulate trust income. Mr Ewart contends that the phrase 'is to be accumulated' in *s686(2)(a) ICTA 1988* is to be construed in a more general way, not limited by the legislation imposing those restrictions.

G [16] It is clear from the evidence that in the majority of cases (if not always) the income and the service charges become a single fund. Further, there is no suggestion that when the fund is applied for the purposes of carrying out maintenance or repairs, this represents a payment of income to the tenants. The funds can be applied in the following ways:

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1. expenditure on repairs;
 2. repayment of surplus to tenants;
 3. application of surplus to future years (indirectly benefiting tenants by reducing the future service charges); and
 4. on termination of a lease, by payment to the landlord.

Does the aggregation of the income with the service charges (received by RCG as capital) amount to accumulation in such a way as to say that this income is 'income to be accumulated' within s686(2)(a) ICTA 1988?

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[17] There is a clear policy reason for treating the income on a similar basis to the service charges. The intention behind s42 LTA 1987 is to protect tenants from the risk of the landlord taking the funds and using them for other purposes. This applies equally to the income derived from the service charges, whether or not that income is kept in a separate fund. In addition, the 'ring-fencing' of the income, as well as the capital, recognises that the landlord should not, as a matter of trust law, profit from its position as trustee.

B

[18] I view the process of acquiring and holding the income as amounting to the addition of that income to the corpus of the fund available for application in the ways set out at para [16] above. Mr Sherry pointed to the possibility, under s42(2) LTA 1987, of creating two separate funds: he indicated that a landlord could set up one fund to contain the service charges and a separate fund to contain the income derived from those charges. I accept that in theory it would be possible to do this, although I have some doubts as to the practicality of segregating 'capital' and 'income' funds in this way. In such a case, what would be the character of the 'income' fund? I consider that it would have the same character as the 'capital' fund, namely a fund collected together for application in the ways listed above. The purpose would not be to maintain income for particular beneficiaries, but to secure a fund for application in the permitted ways.

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[19] Thus, whether or not the fund derived from income from the service charge moneys is held separately from the fund consisting of the service charge moneys themselves, the effect is to add that income to the corpus of the fund available to be applied for the permitted purposes. There is no intention to provide anything by way of income to any person for whose benefit the funds are to be utilised.

E

[20] Addition of the income to the corpus of the fund amounts to accumulation. Reference was made in argument to statements by HMRC that there was an implied power of accumulation in respect of trusts under s42 LTA 1987, and for the reasons just given, I accept that this is the case. The prohibition of accumulations which infringe the rule against perpetuities does not apply to commercial contracts: see *Megarry and Wade* at para 7-177. I accept Mr Ewart's argument that the cases dealing with the respective interests of income beneficiaries and capital beneficiaries in the context of the rule against perpetuities do not assist outside the context of a family settlement. Thus cases dealing with the retention of moneys for the purposes of maintaining property held within a settlement, and whether or not that amounts to accumulation in the context of the interests of the income beneficiaries on the one hand and the capital beneficiaries on the other, do not assist in the context of a statutory trust designed to protect the commercial interests of tenants in respect of moneys paid over to landlords by way of service charges.

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[21] Mr Sherry referred to the tenants as having immediate vested interests, and to the funds being held for an immediate binding purpose, the trust being an express trust to spend the money. The difficulty with these contentions is that the tenants

A have no direct right to the money held by the landlord: the funds are held to be applied for the permitted purposes listed above, and are not necessarily to be applied immediately. The budgeting process results in decisions whether funds are to be spent in the immediate future or are to be retained against future contingencies. Where funds are retained, the tenants are not in a position to ask for the income on those funds to be paid over to them. Where a tenant gives up his tenancy, he has no right to any part of the retained funds, whether income or capital.

B [22] If it is correct that income which becomes part of the overall trust fund held pursuant to *LTA 1987 s42* is to be regarded as accumulated, this would bring that income within the scope of *s686(2)(a) ICTA 1988*. Mr Sherry raised the question of the policy behind *s686*. Is income arising to *s42 LTA 1987* trusts a type of income which ought to be regarded as within *s686* and therefore taxable at the rate applicable to trusts?

C [23] Mr Sherry mentioned the context of *s686*. It related to avoidance of higher-rate tax by long-term accumulations of income. He argued that *s42 LTA 1987*, relating to a statutory trust, had nothing to do with rolling up and compounding income. He also emphasised that the trusts were for the immediate benefit of the tenants. However, I have concluded that a process of accumulation is involved: the combined fund (or funds), comprising income and capital, is then immediately available to be applied for the benefit of the tenants, and that application does not entail preservation of the character of the income when the funds are so applied. As Mr Ewart argued, in the absence of *s686* the income of the trust would be liable only to basic-rate tax. The question is therefore whether there is any basis for excluding what I have decided is the accumulation of income within *s42 LTA 1987* trusts from the application of *s686*.

D [24] The structure of *s686* is that in *subsection (2)(a)* it sets out a general description of the type of income falling within the section – ie, either income which is to be accumulated or income which is payable at the discretion of the trustees. *Section 686(2)(b)-(c)* provides exceptions to the charge. The exceptions in *s686(2)(c)* are specific, relating to charitable trusts and to income on investments etc held for the purposes of certain pension schemes. The inference to be drawn from this is that subject to these specific exceptions, the intention behind the section is that any trust income ‘which is to be accumulated’ is to be treated as within the charge and is therefore liable to tax at the rate applicable to trusts. There is no basis for implying any other limitation of the categories of trust falling within *s686*.

E [25] My conclusion is therefore that the income of trusts within *s42 LTA 1987* is ‘income to be accumulated’ within *s686 ICTA 1988* and is therefore subject to tax at the rate applicable under *section 686(1AA)* and *(1A)*.

F [26] Mr Sherry raised the question of the differences which would result between the position of larger blocks with correspondingly larger trust funds or other units for which large *section 42* funds were held, and smaller or more modern blocks. He argued that in the latter case the level of income in the fund might well mean that in practice there would be no liability under *s686*, whereas for the larger funds this would be inevitable. This side effect of applying *s686* only arises as a result of

changes taking effect from 2005/06 onwards. I do not think that I can take these subsequent changes in the law into account in construing *s686*, nor the changes made to *s686* by the *Finance Act 2006*, to which neither party referred in argument.

[27] Mr Ewart argued in the alternative that if the income was not held to be 'income which is to be accumulated', it would fall within the other limb of *s686(2)(a)* as being 'payable at the discretion of the trustees'. Given my decision on the first point, it is not strictly necessary for me to deal with this submission, but I do so in case the point arises on further appeal. On this question I accept Mr Sherry's argument: the discretion in question under *s686(2)(a)* is a fiduciary one, and I do not consider that RCG as trustee is exercising such a discretion when taking decisions as to the application of the funds held in the *section 42* trust.

[28] I therefore answer the referred question by determining that the income which arose to RCG from the money held on trusts under *s42 LTA 1987* was subject to income tax under *s686 ICTA 1988*.

Counsel

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[2008] WTLR 932

[2008] WTLR 934

[2008] WTLR 936

[2008] WTLR 938

[2008] WTLR 940
