
The Personal Tax Planning Review

THE INCOME TAX TREATMENT OF IRREVOCABLE A&M SETTLEMENTS

Robert Grierson, Barrister¹

Introduction

In this article I explore the tortuous mechanism of s.664(2)(b) and (3) Income and Corporation Taxes Act 1988.

Terms

All section references are to sections of The Income and Corporation Taxes Act 1988.

I use the phrase "current year income payment" to denote a payment out to beneficiaries of settlement income of the year of payment.

Preliminary

Generally, if the trustees of a settlement, during the life of a² settlor, pay any settlement income to or for the benefit of an unmarried minor child of that settlor, then that payment is treated as the income of that settlor and not of the recipient child or any other person. See s.663(1).

If, however, the trustees of the settlement accumulate £500 of income in Year X (which thus becomes capital under general trust law), it is obviously not treated as income of the settlor by s.663(1) alone because there is no actual payment.

Nevertheless, this accumulated sum is caught by s.664(1)(a) as income which "is so dealt with that it, or assets representing it, will or may become payable or

¹ Robert Grierson MA, LLM, 24 Old Buildings, Lincoln's Inn,
London WC2A 3UJ Tel: (071) 242 2744 Fax: (071) 831 8095.

² There can be more than one settlor of a relevant settlement. See the s.670 definition of "settlor" and see s.668.

applicable to or for the benefit of a child of the settlor in the future ...". The consequence of the accumulated sum being caught by s.664(1)(a) is that it is "deemed to be paid to or for the benefit of that child" (see s.664(1)(a)); so that this amount of settlement income is taxed as the income of the settlor parent under s.663 *if* the child is an unmarried minor at the time of the accumulation.

S.664(1)(b) was enacted to deal with **unallocated** accumulated income. The approach of s.664(1)(b) is simply to deem the income to be paid equally on accumulation to the child potential beneficiaries, each of whom may or may not be an unmarried minor at that time of accumulation.

Note that under s.664(1)(a) and (b) it is irrelevant that a child beneficiary may not be an unmarried minor at the future time when the accumulated income will or may become payable or applicable to or for its benefit. The income is deemed to be the settlor's so long as the child is an unmarried minor at the time of the accumulation.

Of course a "child"³ of a settlor is not necessarily a "minor" or indeed an "unmarried minor", so that simply deeming a payment to be made to a child of a settlor will not necessarily cause s.663(1) to operate; the child must also be an unmarried minor.

Irrevocable Settlements

The above provisions are subject to s.664(2) and (3) in the case of *irrevocable* settlements; i.e., where the settlement is irrevocable "at the time when the income is so dealt with", namely at the time of accumulation. See the opening words of s.664(2). In this context "irrevocable" has a special definition. See s.665, which may be stated in very broad terms as providing that the settlement is not "irrevocable" if the settlor retains or may reacquire on the settlement's determination any interest in the settled property.

S.664(2)(a) provides that s.664(1) does not apply to accumulated income "unless and except to the extent that that income consists of, or represents directly or indirectly, sums paid by the settlor which are allowable as deductions in computing his total income ...". I.e., in the case of irrevocable child-beneficiary accumulation and maintenance settlements s.664(1) only applies to the extent that the settlor enjoys a deduction for contributions to the settlement fund; the idea being that if the settlor does not enjoy a deduction for contributions to the settlement then he should not be "further" penalised by having the accumulated

³ Defined by s.670 to include a stepchild and an illegitimate child.

income potentially⁴ taxed as his income under ss.663 and 664(1); and *vice versa* of course.

However, the "let-out" from s.664(1) provided by s.664(2)(a) in the case of non-deductible contributions to irrevocable child-beneficiary accumulation and maintenance settlements is "overridden" by s.664(2)(b) where sums are later actually paid. The word "and" links s.664(2)(a) and (b). Although the word "but" might make s.664(2)(b) more easy to understand on first reading, the word "but" is not grammatically correct because s.664(2)(a) treats accumulated income, whereas s.664(2)(b) treats sums paid.

S.664(2)(b) provides that "subject to subsection (3) below, any sum whatsoever paid thereafter ... to or for the benefit of a child of the settlor, being a child who at the time of the payment is unmarried and below the age of 18, shall be deemed for the purposes of section 663 to be paid as income." Thus, subject to s.664(3), the effect of s.664(2)(b) is that any sum so paid in any given year⁵, whether it represents (a) capital contributed to the settlement, or (b) money which has become capital of the settlement by accumulation of income in earlier years (if any), is deemed to be caught by s.663.

However, as stated, s.664(2)(b) is subject to s.664(3). For the purpose of explaining the effect of s.664(3) let us posit the situation of:

An initial contribution of £10,000 to an irrevocable child-beneficiary accumulation and maintenance settlement

Settlement income in Year 1 of £500, which is not paid out and is thus accumulated as capital

Settlement income in Year 2 of £500, which is paid out in that year and is caught by s.663 (assuming that the relevant beneficiaries are unmarried and minor)

Settlement income in Year 3 of £500.

Payment in Year 3 to minor unmarried beneficiaries of £1,500

⁴ I.e., if the child beneficiaries are also unmarried minors.

⁵ Other than income of that year, payment of which is caught "directly" by s.663 because, as s.664(2)(b) posits, the settlor's recipient child is an unmarried minor.

Question: How is the Year 3 payment of £1,500 taxed?

Answer:

- 1 £500 of the payment is taxed under s.663 "directly" as a current year income payment.
- 2 The remaining £1,000 is *prima facie* taxed under s.663 "indirectly" by virtue of s.664(2)(b). Note: it must be assumed that Year 3 income included in the Year 3 payment **cannot** be taxed twice under s.663; once by s.663 "directly", and again by virtue of the s.664(2)(b) deeming. See paragraph 4 below regarding the "application" of s.664(2)(b).
- 3 S.664(3) provides that s.664(2)(b) does **"not apply if and to the extent that the sum paid as mentioned in that paragraph [i.e., the full £1,500; not just the £1,000 arrived at by deducting the £500 payment of Year 3 income "directly" taxed by s.663] together with any other sums previously so paid⁶ [i.e., the income of Year 2 distributed in that year = £500, even though there is no need for s.664(2)(b) to deem it within s.663 because it is "directly" caught by s.663] [thus making a total of £2,000] ... exceeds the aggregate amount of the income which ... has been paid to or for the benefit of a child⁷ of the settlor [i.e., income of the settlement paid out in the year in which it arises = £500 in Year 2 + £500 in Year 3 *itself*! = £1,000] or [i.e., "plus income"] dealt with as mentioned in subsection (1) above ... [i.e., the £500 accumulated in Year 1] [so that the said aggregate is £1,500]"**.
- 4 Thus in our question s.664(2)(b) does not apply to the extent of £2,000 minus £1,500; i.e., it does not apply to the extent of £500. This raises the *prior* question of the extent to which s.664(2)(b) *prima facie* "applies". The answer is to the extent of £1,000 only, i.e., excluding the £500 current year income payment in Year 3. I.e., there is a distinction between the amount to which s.664(2)(b) applies, which excludes any amount of the payment taxed directly by s.663 because it represents an amount of settlement income of the year of the payment and the settlor's recipient child is an unmarried minor, and the amount of "any sum

⁶ This includes both capital and current year income payments.

⁷ Note that it is immaterial whether such child is an unmarried minor.

whatsoever paid thereafter" within s.664(2)(b) and as referred to in s.664(3) as "the sum paid as mentioned in that paragraph"⁸.

- 5 Thus the sum of £1,000 to which s.664(2)(b) *prima facie* applies is reduced to £500 by s.664(3), accurately reflecting the fact that in Year 3 the £1000 capital distribution element of the £1,500 paid only represented accumulated income to the extent of £500. The other £500 effectively coming out of the settlement funds of £10,000 is in the result not taxed by s.664(2)(b).

The above discussion of s.664(2)(b) and (3) restated in greater detail and with a more extensive example

Broadly, the object of s.664(3) is to "strip out" from the amount, deemed by s.664(2)(b) "for the purposes of section 663 to be paid as income", any amount of the capital contributed to the settlement (rather than additional capital arising as a result of accumulation of income) which is distributed as part of the payment.

Thus s.664(3) provides that the amount to which s.664(2)(b) *applies* is reduced by the result of [(1)+(2)-(3)-(4)] in the following:

- (1) The instant s.664(2)(b) payment⁹, PLUS
- (2) All previous s.664(2)(b) payments¹⁰, MINUS
- (3) All current year income payments to date¹¹, i.e., including any such payment contained in the amount of the instant year's s.664(2)(b) payment, MINUS
- (4) All income accumulated to date as per s.664(1).

⁸ Cf. the ensuing words in s.664(3) "together with any other sums previously so paid".

⁹ Which includes current year income payments taxed "directly" by s.663.

¹⁰ Each of which can include or be alone current year income payments taxed "directly" by s.663.

¹¹ Taxed "directly" by s.663 *if* the child recipient is an unmarried minor. Note that in the following example all payments making up element (3) of any s.664(3) reduction are taxed "directly" by s.663 in their respective years of being made as the child beneficiaries are stated to remain unmarried minors throughout all years discussed.

Let us now take the following example -

An accumulation and maintenance settlement is created in favour of the settlor's unmarried minor children with a contribution to trustees of £10,000. The children remain unmarried minors throughout all years discussed. The settlement is irrevocable within the meaning of s.665 so that s.664(2) and (3) apply. Assume that no part of the £10,000 is deductible in computing the settlor's total income, so that s.664(1) does **not** deem future accumulations of income by the trustees to be paid out and caught by s.663. See s.664(2)(a). Then in -

Year 1 -	Income of £500 Payment of £250 = £250 accumulated
Year 2 -	Income of £750 Payment of £250 = £500 accumulated
Year 3 -	Income of £750 Payment of £500 = £250 accumulated
Year 4 -	Income of £1,000 Payment of £3,500
Year 5 -	Income of £1,500 Payment of £2,000
Year 6 -	Income of £1,000 Payment of £500 = £500 accumulated
Year 7 -	Income of £1,000 Payment of £2,000
Year 8 -	Income of £1,000 Payment of £500 = £500 accumulated
Year 9 -	Income of £1,000 Payment of £1,250

The taxation results for these years are -

- Year 1 (a) £250 taxed under s.663
(b) £250 accumulated but not taxed by s.664(1): see s.664(2)(a)
- Year 2 (a) £250 taxed under s.663
(b) £500 accumulated but not taxed by s.664(1): see s.664(2)(a)
- Year 3 (a) £500 taxed under s.663
(b) £250 accumulated but not taxed by s.664(1): see s.664(2)(a)
- Year 4 (a) £1,000 of the £3,500 payment is taxed "directly" by s.663
(b) s.664(2)(b) *prima facie* applies¹² to £2,500 of the £3,500 payment. This £2,500 is reduced in accordance with s.664(3) by the result of [(1)+(2)-(3)-(4)] below:
- (1) £3,500 = the sum paid as mentioned in s.664(2)(b)
- (2) Any other sum previously so paid = £1,000 =
£250 (Yr 1 "direct" s.663 payment) +
£250 (Yr 2 "direct" s.663 payment) +
£500 (Yr 3 "direct" s.663 payment)

¹² It is essential to grasp the distinction between:

- (1) The amount to which s.664(2)(b) *applies* (i.e., which is *deemed* by s.664(2)(b) to be a s.663 payment). This amount excludes any part of the s.664(2)(b) *payment* taxed "directly" by s.663 because it is a current year income payment; AND
- (2) "the sum paid as mentioned in that paragraph [i.e., s.664(2)(b)] together with any other sums previously so paid"; namely the full amount of the payment which *does include* any current year income element of such payment taxed "directly" by s.663.

(3)¹³ Total s.663 current year income payments *to date* thus including any "direct" s.663 amount in the Year 4 payment of £3,500 = (2) above + £1,000 = £2,000

(4) Total amount *to date* "dealt with as mentioned in" s.664(1),¹⁴ i.e., total accumulations to date = £1,000 =

£250 (Yr 1 accumulation) +
£500 (Yr 2 accumulation) +
£250 (Yr 3 accumulation)

= REDUCTION BY £[3,500 + 1,000 - 2,000 - 1,000], i.e., by £1,500. Thus the amount to which s.664(2)(b) in fact applies (after the s.664(3) reduction) is £2,500 - £1,500 = £1,000. It is thus effectively the total accumulated income of £1,000 from Years 1, 2 and 3 which is deemed by s.664(2)(b) to be within s.663. The £1,500 reduction is effectively the amount by which the original contribution to capital of £10,000 is depleted by the £3,500 payment. This can be tested by seeing that the total income of Years 1-4 = £2,000 = £1,000 accumulated in Years 1, 2 and 3 + £1,000 income of Year 4. Thus the depletion of original capital by the £3,500 payment = £3,500 - £2,000 = £1,500

Year 5 (a) £1,500 of payment taxed "directly" by s.663 as current year income payment

(b) s.664(2)(b) *prima facie* applies to £500 of the £2,000 payment. This £500 is reduced in accordance with s.664(3) by the result of [(1)+(2)-(3)-(4)] below:

¹³ Note that in this example all payments making up element (3) of any s.664(3) reduction are taxed "directly" by s.663 in their respective years of being made as the child beneficiaries are stated to remain unmarried minors throughout all years discussed.

¹⁴ It is also essential to distinguish between:

- (1) An amount of income accumulated and thus "dealt with as mentioned in" s.664(1), and
- (2) An amount of income to which s.664(1) *applies*.

Remember that, in the present case of a non-deductible £10,000 contribution to settlement, s.664(1) does not apply to accumulations. See s.664(2)(a).

- (1) £2,000 = the sum paid as mentioned in s.664(2)(b)
- (2) Any other sum previously so paid = £4,500 =
£250 (Yr 1 "direct" s.663 payment) +
£250 (Yr 2 "direct" s.663 payment) +
£500 (Yr 3 "direct" s.663 payment) +
£3,500 (Yr 4 s.664(2)(b) payment)
- (3)¹⁵ Total s.663 current year income payments *to date* thus including any "direct" s.663 amount in the Year 5 payment of £2,000 = (3) at Year 4 above plus £1,500 = £2,000 + £1,500 = £3,500
- (4) Total amount *to date* "dealt with as mentioned in" s.664(1), i.e., total accumulations to date = £1,000 (as per Year 4 calculation)

= REDUCTION BY £[2,000 + 4,500 - 3,500 - 1,000], i.e., by £2,000. Thus the amount to which s.664(2)(b) in fact applies (after the s.664(3) reduction) is £500 - £2,000 = NIL

There is no provision for setting off the £1,500 unrelieved depletion of original capital against current year income payments of past, instant or future years to relieve them from being "directly" taxed by s.663.

At first sight it might appear that there is a defect in s.664(3); i.e., that it reduces the amount to which s.664(2)(b) *prima facie* applies not by the amount by which the original capital has been (further) depleted by the payment in the instant year, but instead reduces it by the total amount of such depletion to date (including that depletion effected by the instant payment). Thus the Year 5 reduction under s.664(3) above is £2,000, which is the cumulative depletion to end of Year 5 (income for all years to end of Year 5 = £4,500; total payments to end of Year 5 = £6,500).

This "defect" can again be seen from the fact that s.664(3) effectively directs a reduction by (a) Total Payments to Date (i.e.,

¹⁵ Note that in this example all payments making up element (3) of any s.664(3) reduction are taxed "directly" by s.663 in their respective years of being made as the child beneficiaries are stated to remain unmarried minors throughout all years discussed.

(1)+(2)) MINUS (b) Total Income¹⁶ to Date (i.e., (2)+(3)). This reduction is thus the total depletion in original capital to date; rather than the amount by which the original capital has been (further) depleted by the current year s.664(2)(b) payment alone.

This "defect", albeit perhaps logically unsatisfying at first sight has no consequence; for, this apparently unnecessary inflation in the reduction cannot be used to relieve past, instant or future year payments "directly" taxed by s.663. Indeed it is not a defect at all, as is explained in the penultimate paragraph of this article.

Year 6 (a) £500 taxed under s.663

(b) £500 accumulated but not taxed by s.664(1): see s.664(2)(a)

Year 7 (a) £1,000 of payment taxed "directly" by s.663 as current year income payment

(b) s.664(2)(b) *prima facie* applies to £1,000 of the £2,000 payment. This £1,000 is reduced in accordance with s.664(3) by the result of [(1)+(2)-(3)-(4)] below:

(1) £2,000 = the sum paid as mentioned in s.664(2)(b)

(2) Any other sum previously so paid = £7,000 =

£250 (Yr 1 "direct" s.663 payment) +
 £250 (Yr 2 "direct" s.663 payment) +
 £500 (Yr 3 "direct" s.663 payment) +
 £3,500 (Yr 4 s.664(2)(b) payment) +
 £2,000 (Yr 5 s.664(2)(b) payment) +
 £500 (Yr 6 "direct" s.663 payment)

¹⁶ I.e., whether paid out in the year of its arising or accumulated.

- (3)¹⁷ Total s.663 current year income payments *to date* thus including any "direct" s.663 amount in the Year 7 payment of £2,000 = £5,000 =

£250 (Yr 1 "direct" s.663 payment) +
 £250 (Yr 2 "direct" s.663 payment) +
 £500 (Yr 3 "direct" s.663 payment) +
 £1,000 (Yr 4 "direct" s.663 payment) +
 £1,500 (Yr 5 "direct" s.663 payment) +
 £500 (Yr 6 "direct" s.663 payment) +
 £1,000 (Yr 7 "direct" s.663 payment)

- (4) Total amount *to date* "dealt with as mentioned in" s.664(1), i.e., total accumulations to date = £1,000 (as per Year 4 calculation) + Year 6 accumulation of £500 = £1,500

= REDUCTION BY £[2,000 + 7,000 - 5,000 - 1,500] i.e., by £2,500. Thus the amount to which s.664(2)(b) in fact applies (after the s.664(3) reduction) is £1,000 - £2,500 = NIL

To test that £2,500 = the total depletion in original capital to end of Year 7, find total income to end of Year 7 (£6,500) and subtract total payments to end of Year 7 (£9,000) = - £2,500

- Year 8 (a) £500 taxed under s.663
- (b) £500 accumulated but not taxed by s.664(1): see s.664(2)(a)
- Year 9 (a) £1,000 of payment taxed "directly" by s.663 as current year income payment
- (b) s.664(2)(b) *prima facie* applies to £250 of the £1,250 payment. This £250 is reduced in accordance with s.664(3) by the result of [(1)+(2)-(3)-(4)] below:

¹⁷ Note that in this example all payments making up element (3) of any s.664(3) reduction are taxed "directly" by s.663 in their respective years of being made as the child beneficiaries are stated to remain unmarried minors throughout all years discussed.

(1) £1,250 = the sum paid as mentioned in s.664(2)(b)

(2) Any other sum previously so paid = £9,500 =

£250 (Yr 1 "direct" s.663 payment) +
 £250 (Yr 2 "direct" s.663 payment) +
 £500 (Yr 3 "direct" s.663 payment) +
 £3,500 (Yr 4 s.664(2)(b) payment) +
 £2,000 (Yr 5 s.664(2)(b) payment) +
 £500 (Yr 6 "direct" s.663 payment) +
 £2,000 (Yr 7 s.664(2)(b) payment) +
 £500 (Yr 8 "direct" s.663 payment)

(3)¹⁸ Total s.663 current year income payments *to date* thus including any "direct" s.663 amount in the Year 9 payment of £1,000 = £6,500 =

£250 (Yr 1 "direct" s.663 payment) +
 £250 (Yr 2 "direct" s.663 payment) +
 £500 (Yr 3 "direct" s.663 payment) +
 £1,000 (Yr 4 "direct" s.663 payment) +
 £1,500 (Yr 5 "direct" s.663 payment) +
 £500 (Yr 6 "direct" s.663 payment) +
 £1,000 (Yr 7 "direct" s.663 payment) +
 £500 (Yr 8 "direct" s.663 payment) +
 £1,000 (Yr 9 "direct" s.663 payment)

(4) Total amount *to date* "dealt with as mentioned in" s.664(1), i.e., total accumulations to date = £1,500 (as per Year 6 calculation) + Year 8 accumulation of £500 = £2,000

= REDUCTION BY £[1,250 + 9,500 - 6,500 - 2,000], i.e., by £2,250. Thus the amount to which s.664(2)(b) in fact applies (after the s.664(3) reduction) is £250 - £2,250 = NIL

¹⁸ Note that in this example all payments making up element (3) of any s.664(3) reduction are taxed "directly" by s.663 in their respective years of being made as the child beneficiaries are stated to remain unmarried minors throughout all years discussed.

To test that £2,250 = total depletion in original capital to end of Year 9 find the total income to end Year 9 (£8,500) and subtract total payments to end of Year 9 (£10,750) = - £2,250.

Note that the total depletion in the *quantum* of contributed capital to the end of Year 9 is LESS than that to end of Year 7. It can be perceived from this that the s.664(3) *quantum* of reduction is not a defect at all, but allows the trustees to accumulate income to bring the capital in the settlement back up to the level of the original fund; with accumulations to the extent of this "topping up" (but only to that extent) not being deemed by s.664(2)(b) to be s.663 income payments when later paid out (i.e., as capital). Thus in the above example, as a result of the s.664(3) formula, £250 of the £500 accumulation in Year 8 is NOT "used" by s.664(2)(b) to deem the remaining £250 of the Year 9 payment to be within s.663.

Conclusion

Fresh legislation in this area might be more lucid.