

Handle with care

David Coldrick and Lynne Bradey highlight the advantages – but also the complexities – of PI trusts



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'A personal injury trust does not need to have a special generic title or be one sort of trust or another at law to be a personal injury trust. It is the source of the trust fund which determines the trust's nature.'

The High Court judgment in *Phelps v Stewarts & anr* on 2 July highlights the need for genuinely specialist trust advice on personal injury trusts.

Before looking at the facts of the case and the preceding professional negligence action, it is helpful to examine why a personal injury trust (also known variously as a compensation protection trust and a special needs trust) should be created at all, and the options and the consequences involved.

Often, a personal injury client will be receiving some type of financial or practical assistance from the DWP or a local authority. If that help is in the form of a means-tested 'income-related benefit' (such as income support, pension credit guarantee, housing benefit or council tax benefit) or otherwise (such as for care at home or in another residential setting), it is vital that the client is advised that those benefits are likely to be stopped or reduced, if they receive compensation but do not put it into a personal injury trust.

Advantages of a personal injury trust

From some of the benefits mentioned there also flow other advantages, such as free prescriptions, eye tests and dental care. As with taxes, benefits should not be addressed by the adviser in isolation. There is a limited 'period of grace' of 52 weeks from the date of receipt of the first payment arising from the personal injury. But this 'temporary disregard' is only applicable for certain limited means-testing purposes and has some overcomplicated fine detail which can seriously limit its application. In particular, it is a one-off allowance and does not apply to later payments. In larger cases there will often be an interim payment which will trigger and eliminate the grace period for all time. For all but the smallest

awards, which will be spent quickly, the temporary disregard delays, but does not solve, the problem.

It should also be noted that, presently, there is no temporary disregard for payments for a personal injury to a person who resides in residential care. In such cases only by having a personal injury trust for the payment on account of the personal injury will the amount ever be disregarded under the regulations.

Further, advice on personal injury trusts does not only need to be given if a person is currently in receipt of means-tested benefits. A person may not be in current need of means-tested benefits but may potentially have access to them in the future if their assessable capital for means-testing purposes is low.

There are also other positive advantages of personal injury trusts apart from the retention of means-tested benefits. That is particularly, but not exclusively, in the case of older, very young, mentally incapable or other vulnerable clients. These are the kinds of advantages of trust arrangements which readers will be more familiar with. The injured client may:

- have no experience of handling a large sum of money;
- want the protection which trustees can offer against grasping relatives;
- have unstable mental conditions which renders the use of trustees helpful;
- just want to get on with their lives without having to concern themselves with financial administration; and/or
- fear the impact of divorce and separation on their finances and want to try to 'ring-fence' their resources in some way (at least by way of general differentiation from the rest of the 'family pot'.)

There are countless possibilities, and readers will be aware that a proper appreciation of these situations appears to have been singularly lacking in the drafting of the Finance Act 2006.

The most important point to note is that a personal injury trust does not need to have a special generic title, or be one sort of trust or another at law to be a personal injury trust. It is the source of the trust fund which determines the trust's nature. Client needs, their family circumstances and the relevant law should dictate the type of trust. But whatever legal type of trust it is, if it is funded by an award of compensation for a personal injury then it will be a 'personal injury trust'.

For benefits efficiency to be achieved, the use of any type of trust structure is possible. But not all types of trust are desirable for tax purposes. In the case of *Phelps* this point of departure between benefits efficiency and tax efficiency proved highly problematic.

Tax and personal injury trusts

The majority of personal injury trusts are bare trusts adapted to the particular client's circumstances and usually with a fairly limited set of administrative powers. A transfer into a personal injury bare trust attracts no IHT charge, and for that matter all income and capital gains are assessed on the settlor. There is no relevant transfer of value against which an IHT charge can apply. By way of contrast, a transfer into a personal injury discretionary trust (and, since the Finance Act 2006, a personal injury life interest-type trust) brings the trust fund within the application of the 'relevant property regime' for IHT purposes. That triggers a 20% IHT charge on the amount over the then nil-rate band of the injured settlor on

entry, but still counts as part of the settlor's estate for IHT purposes because, as the settlor is a discretionary beneficiary of the trust, the gift with reservation of benefit rules apply.

By way of note, despite their name, 'trusts for the disabled' under the old and new (post-FA 2006) s89 IHTA 1984

to seek some contribution from the litigation firm who acted for Mr Keating. This part did not settle and thus full judgment was given.

Mr Keating was awarded a total of approximately £1m for his injuries. This started with an interim payment of

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are not commonly used in the context of personal injury trusts. There are simpler vehicles that suit most cases not involving predatory third parties or injured clients who are personally prone to financial profligacy.

The facts in Phelps

There were two parts to the *Phelps* case. It centred on trust advice given to a client, Mr Keating, who had suffered serious spinal injuries in a road traffic accident. The award was large, well over his nil-rate band for IHT purposes. The personal injury trust used was a discretionary trust. A significant IHT entry charge was therefore triggered on the transfer of the award into trust and this had to be paid from the trust fund.

- The first part of the case concerned an action against the solicitor who had drafted and advised on the trust, which was settled by mediation.
- The second part of the case concerned an attempt by that solicitor

£35,000 and (arriving in several later parts) £325,000, £625,000 and £20,000.

Stewarts Solicitors handled Mr Keating's claim but did not deal with personal injury trust matters and thus referred the client on to Ms Phelps for advice. She advised the clients, who were 'unsophisticated persons' in the words of Bernard Livesey QC, the Deputy Judge.

There was some dispute over what oral advice about taxation and trusts was given at the time, when the litigation solicitor from Stewarts was also present.

Ms Phelps also argued that her retainer ought to have been limited to the advice for the interim payment only. She further contended that she would not expect any further payments into the trust to be made without consulting her. On this basis she claimed that Stewarts Solicitors should be held liable to pay the total of the initial IHT entry charge.

The judge found that Ms Phelps' retainer was such that she ought to have advised on the later payments and that she had been told about an expected

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Phelps v Stewarts & anr
[2007] WTLR 1267

payment in excess of Mr Keating's IHT-free nil-rate band. He also noted that Mr Keating was not an expert on trust matters and so could hardly be expected to be able to define the terms of the retainer accordingly. In effect, how can a client who does not know there could be adverse tax consequences agree to a retainer which excludes this advice? Ms Phelps' letter to the client also failed to mention the IHT charge which might be expected to arise upon future payments into the trust.

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Retainers were discussed in detail in the judgment, but the judge ultimately concluded that these issues had been raised by Ms Phelps as:

... a smoke screen to disguise the fact that Ms Phelps did not appreciate that payments into a discretionary trust attracted an initial tax charge, a fact which she was not prepared to admit.

He also stated that: 'even if there were confusion, the obligation lay upon her to take appropriate steps to clarify

the understanding of her client... and this she failed to do.'

There was evidence that a similar error had been made on another case referred to Ms Phelps by Stewarts Solicitors where a discretionary trust was also set up. In the similar case, the initial interim payment was already over the relevant client's nil-rate band for IHT purposes and a letter from Ms Phelps clearly showed that she expected further substantial sums to be placed in that trust.

In commenting on this case, the judge also noted for good measure that the interim payment was intended to be used for the purchase of a house, which

would be a disregarded asset for means-tested benefits purposes anyway, so there was no immediate need for it to be placed in trust. It can be useful for residences to be placed in, for example, a personal injury bare trust if there is no taxation disadvantage, just in case they are sold later, but in this case there were obviously serious disadvantages. To quote the judge again:

She [Ms Phelps] was therefore presented with a complete 'no brainer': there was simply no need to put the money into a

trust; it would achieve no benefit of any significance and on the debit side of the equation would both use up a potentially valuable IHT allowance and incur a further liability to an immediate tax charge of £12,000.

Indeed. Interestingly, Stewarts Solicitors did agree to pay the IHT entry charge on the final £20,000 in the case involving Mr Keating because by the time it was paid over, concerns had been raised within that firm as a result of the advice on the other matter and whether it was advisable to put any further sums into trust until the issue was resolved. That payment was made by mistake after the date of a letter to this effect to the relevant financial adviser whilst the litigation solicitor with conduct of the file was on holiday. Solicitors should never go on holiday.

Conclusion for practitioners

The moral of the story really has to be not to meddle in legal matters outside your speciality. To advise clients about personal injury trusts, a comprehensive knowledge of the types of trust available, their tax consequences, benefits impact and other effects is essential.

One final thought. Ms Phelps paid £200,000 plus costs, as well as, we presume, the costs of the litigation against Stewarts Solicitors all the way to trial. Her fee for drafting the trust initially? Just £500 plus VAT. A bargain.

It is clear that there can be significant benefits-related advantages if a personal injury trust is founded. ■

The capital disregard

The 'capital disregard' for income support and other means-tested benefits is contained in paragraph 12 of Schedule 10 to the Income Support (General) Regulations 1987. This states that:

... where the funds of a trust are derived from a payment made in consequence of any personal injury to the claimant, the value of the trust fund and the value of the right to receive any payment under that trust [are disregarded].

There are also mirror provisions in paragraphs 44(a) and 45(a) relating to personal injury compensation administered by the Court of Protection on behalf of a mentally incapable injured person.

Regulation 51(1)(a) of the Income Support (General) Regulations also exempts a personal injury trust situation from the 'deprivation of capital'/ notional capital rules. These would usually impute a trust founded by a benefits claimant to that claimant, otherwise everyone would found a trust to enhance their entitlements. This recognises the special status of personal injury trusts.

For the purposes of long-term care provided under paragraph 10 of Schedule 4 to the National Assistance (Assessment of Resources) (NA(AR)) Regulations, the following capital is to be disregarded: 'any amount which would be disregarded under paragraph 12 of Schedule 10 to the Income Support Regulations (personal injury trusts)'. This mirrors the income support and other means-tested benefit regulations. In addition, the deprivation of capital aspect of the notional capital rules does not apply when a person founds a personal injury trust. Usually, if a person requiring care had founded a trust with the aim of reducing their liability to pay for their care, they could be treated as still owning the money in the trust fund. It would be assessed as notional capital and would be included when assessing how much capital the resident had. NA(AR) Regulation 25(1) states:

A resident may be treated as possessing actual capital of which he has deprived himself for the purpose of decreasing the amount that he may be liable to pay for his accommodation except (a) where that capital is derived from a payment made in consequence of any personal injury and is placed on trust for the benefit of the resident...