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Personal injury trusts - the PITs? (Pt 1)

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***S.L.T. 89** *In the first of a two part article on personal injury trusts, the author discusses what PITs are and their advantages, their tax and benefits treatment and divergent views in the profession of how PITs should be established for children.*

The author would like to begin by answering what might at first blush appear to be a rhetorical question in the title with a -- perhaps. We may not like them, particularly having regard to the dearth of guidance with respect to the challenges which they pose (and which we shall examine presently) but personal injury trusts ("PITs") are ignored at the practitioner's peril. In Scotland there is remarkably little discussion -- whether in legal writing or decided cases -- relating to PITs. Nevertheless there is clearly a real awareness in the profession of the fact that we ought to be thinking about PITs -- and more than thinking about them. A measure of the degree to which the profession is exercised by PITs is to be had from the fact that, in the wake of Yvonne Evans' recent article on the subject ("Personal injury trusts: benefits and PIT falls", *The Journal of the Law Society of Scotland*, 14 February 2011) a lunchtime seminar in the popular Edinburgh Tax Network series attracted a capacity audience (100) in the Mackenzie Building on the day after the Budget.

So we practitioners know that we ought to want to know about PITs. And indeed, so we must. Personal injury practitioners who would rely for drafting on specialist counsel or solicitor colleagues need to have, at the very least, a general awareness of PITs even if they would never themselves consider undertaking the settling of such trusts. A moment's consideration tells one that the need for a PIT represents, on the one hand, a means of preserving entitlement to benefits which may or may not abate damages. On the other, it is a source of additional cost. In the round it therefore has a bearing on *quantum* of damages. To take one example, para.12 of Sch.10 to the Income Support (General) Regulations 1987 provides: "Where the funds of a trust are derived from a payment made in consequence of any personal injury to the claimant or the claimant's partner, the value of the trust fund and the value of the right to receive any payment under that trust." For reasons upon which the writer does not propose to expand here -- which extend beyond the scope of this article, primarily concerned, as it is, with the means whereby PITs are established -- but which receive treatment in Coldrick and Bradey, *Personal Injuries Trusts* (4th edn), Chs.1 and 3 (Yvonne Evans also touches upon the matter), it is understood that, for the moment at least, a trust, even a bare trust, if appropriately drafted can result in a disregard of the settled capital so as to preserve an entitlement on the part of a disabled person to various means tested benefits. In many instances, the PIT will be essential and any preservation of benefits a precarious spin off advantage.

Why do PIT smatter? Their impact on damages

That potential saving has been the source of a contention in English personal injuries cases to the effect that it is incumbent upon an injured claimant to mitigate his loss by putting himself (if need be, by settling a trust) in a position to enjoy benefits which would go to diminish the defendant's liability in damages: *Freeman v Lockett* [2006] EWHC 102; [2006] P.I.Q.R. P23; *Crofton v NHS Litigation Authority* [2007] EWCA Civ 71; [2007] 1 W.L.R. 923. In both the former case at first instance and, *obiter*, in the latter Court of Appeal decision, there are observations to the effect that there is no good

reason why the public purse should bear the relative (care) cost in the form of means tested benefits rather than the tortfeasor in the form of damages. In *Crofton*, the court expressed that view notwithstanding its recognition of what Longmore LJ described in *Sowden v Lodge* [2004] EWCA Civ 1370; [2005] 1 W.L.R. 2129; [2005] 1 All E.R. 581, as an “instinctive feeling that if no award for care is made at all, on the basis that it will be provided free by local authorities, the defendant and his insurers will have received an undeserved windfall” and the counter argument that, “if the claimant does not have to give credit for benefits that he will receive from the state as a result of his personal injury, then on the law as it currently stands, he will make double recovery” ([2007] 1 W.L.R., pp.944-945). The latter anomalous consequence flowed from the court's considering that they could “see no good policy reason why the care costs in a case such as this should fall upon the public purse” (p.945). But the members of the Court of Appeal considered that to avoid the attendant consequence of potential double recovery was a matter of policy for Parliament.

In *Freeman v Lockett* Tomlinson J stated that he recoiled “from the notion that [claimants'] failure to avail [themselves] of a state benefit could in the circumstances be characterised as ***S.L.T. 90** an unreasonable failure to mitigate loss” ([2006] P.I.Q.R., p.345). The circumstances included the fact that the claimant had given evidence to the effect that she did not want to be reliant on state benefits and that, if she made full recovery from the defendant, she would not be applying to the local authority for care. It is a short step from Tomlinson J's conclusion that -- at any rate on the facts of that case -- the “failure” of the claimant to avail herself of state benefits was not unreasonable, to concluding also that there was no obligation to settle a personal injuries trust. Generally, the Court of Appeal in *Crofton* endorsed Tomlinson J's reasoning. At p.946 it was said:

“A sufficient basis for [Tomlinson J's] decision was his finding that, provided that no deduction on account of the possible receipt of state or local authority funding was made from her award of damages, the claimant would withdraw her application for funding; she wanted to rely exclusively on private funding for her care.

“But he would in any event have refused to make any reduction in the claimant's damages on account of direct payments for other reasons. He said, at para.35, that there was no principled basis on which the court could estimate what funding the claimant could reliably expect to receive from the local authority for the rest of her life. The court ‘does not speculate unnecessarily or in an unprincipled manner -- I cannot understand how it can be appropriate to impose upon the claimant the unnecessary risk that funding from an alternative source may cease or be reduced rather than simply to order the provision of the fund in its entirety.’”

The Court of Appeal went on to comment that Tomlinson J had been influenced in such broader observations by the “fragility of the policy from which the right to receive direct payments derived” (p.946), but that in a case where the court finds that a claimant will receive direct payments for at least a certain period of time they must be taken into account in the assessment of damages.

In a case such as *Freeman v Lockett* where the court finds that a pursuer intends to rely on private funding, it seems likely that prospective benefits do not need to be taken into account in assessing damages, and that therefore the question whether a PIT will or will not be settled is immaterial. In a different state of fact it could be otherwise. The writer finds the contention that there might be an unreasonable failure to mitigate loss on the part of a pursuer through an omission to set up a PIT so as to preserve a somewhat conjectural entitlement to means tested benefits unattractive. One would hope that our courts might -- but who knows how this would play out.

However that may be, it is just another way of saying that the presence or absence of a PIT has the potential for affecting the damages computation because of its possible impact. And it involves costs which the pursuer should take into account in computing damages. So we all need to know about PITs to a greater or lesser extent.

PITs -- what are they?

They are no one single thing. They may be anything from a bare trust to one of the Inheritance Tax Act 1984 ("IHTA") privileged disabled persons settlements under ss.89, 89A or 89B. Generally, they should not be a non-statutory discretionary trust or a non-statutory self settled interest in possession ("IIP") trust in favour of the disabled person. Discretionary trusts have always come within the IHTA Ch.III "relevant property" régime involving entry charges, periodic charges and exit charges. The entry charges and periodic charges will diminish the fund available in the disabled person's lifetime for his benefit. Since the changes made by the Finance Act 2006, an ordinary IIP by self settlement on the part of the disabled person will also come within the relevant property régime. In most cases, this will not be what is wanted. It is to the detriment of the injured person, whose interests have to be centre stage. The statutory trusts elide the relevant property régime because they involve either a deemed or actual qualifying (post 2006) interest in possession. They may afford the opportunity which discretionary trusts typically afford for *ad hoc* estate planning at a distant date in circumstances which could not have been anticipated at the date of settlement.

The statutory IHT trusts are of four sorts:

1. A s.89 disabled person's trust. This is a discretionary trust in which there is a deemed IIP. The inheritance tax treatment is thus that which would attend the taxation of property equivalent to that in which the deemed IIP subsists, but which the disabled person owned absolutely. Because the IIP is deemed rather than actual, there are certain capital gains tax (CGT) and other disadvantages. The CGT uplift by deemed disposal on death does not apply. Full CGT annual exemptions will not be available.

For the purposes of s.89 (and s.89B(1)(c) below), the disabled person, to be ***S.L.T. 91** regarded as such for the statutory test, must satisfy one of the following criteria in s.89(4)(a) to (c): he must be incapable, by reason of mental disorder within the meaning of the Mental Health Act 1983 of administering his property or managing his affairs; in receipt of attendance allowance (so 65 or older); and there must be one beneficiary (for there may be more) of the trust in receipt of the care component of disability living allowance under s.71 of the Social Security Contributions and Benefits Act 1992 at the middle or highest rate. This reflects pretty severe disability.

2. A s.89B(1)(c) IIP trust. This may be settled by a third party (*inter vivos* or by will trust) or self settled by the disabled person. Either way, one of the four s.89 criteria for disability must be met, rather than anticipated. The fact that there is an actual rather than a deemed IIP opens up the prospect of getting CGT uplift on death, the making of potentially exempt transfers and full CGT annual exemption/vulnerable beneficiary relief.

3. A s.89A self settlement of an anticipatory discretionary trust

4. A s.89B(1)(d) self settlement of an anticipatory life interest for a person expecting to become disabled

-- in each of categories 3 and 4, for a person expecting to become disabled.

The writer proposes to say no more about the trusts referred to at three and four which may be self settled in anticipation of disability satisfying the statutory test. Those interests will tend not to have much application to PITs. It may be possible to figure a case in which injury leads to a condition in which further deterioration and disability is to be anticipated. Usually, however, the consequences of personal injury will be all too clear.

Bare trusts are transparent and tax neutral. The estate will devolve according to the rules of intestacy or by reference to any will which has been or may be (e.g. under the Adults with Incapacity (Scotland) Act 2000 ("AWISA")) made in respect of the incapable person. Because the bare beneficiary is absolutely entitled as against the bare trustee, the capital gains tax treatment and reliefs will be those of an individual. On one view, where one is dealing with a person who, in adulthood does not/will not have the capacity to demand a denuding, a bare trust may be all that is necessary, or desirable. It is understood that in English practice it is the norm in such cases: Coldrick on *Personal Injuries Trusts* (and see below).

The above is a summary, doubtless at the expense of strict accuracy -- certainly of completeness -- of the trusts and their tax treatment. The writer has purposely refrained from rehearsing the qualifying conditions, disability aside, for the respective trusts. In particular, on the view that recital of statute is simply a bore, he has said little of the substance of the interests which qualify. Anyone interested can find these in the IHTA. The challenge posed consists more in the drafting of trusts which exploit the provisions than in finding/understanding the conditions themselves. This article is not primarily about tax. As will presently be evident, long before one gets to the niceties of tax treatment, there are property and procedural issues of Byzantine complexity which lie in the way of settling a trust at all.

Why would anyone want a PIT?

To an extent, we have already touched on this. There is the potential for protecting means tested benefits. This may or may not impact on quantum, according to circumstances. There may be some scope for tax planning.

Pressing reasons why one might want to establish a PIT for an injured person would be because he is a child or an adult incapable of managing his own affairs -- or a child who is likely to grow up to be such an adult. For the adult capable of managing his own affairs, there may be other reasons of personal preference for wanting to establish a PIT. For present purposes we are not really concerned with that situation.

In catering for the interests of those who are/are likely to be incapable adults, considerations which might favour the use of a trust include the avoidance of the costs associated with guardianship and, in particular, procuring bonds of caution. Of course, the trust will also involve attendant costs, particularly if (as is vital in any substantial case) professional trustees and a charging clause are included.

With appropriately chosen trustees it is generally considered that an efficiency and responsiveness is achievable which simply cannot be had by other means.

It is possible that in cases where there is a very large award, there may be some potential for IHT planning to be undertaken incidentally.

Who can benefit from it and how?

In dealing with children and adults with incapacity, it is essential not to lose sight of the ***S.L.T. 92** fact that any trust established must be first and foremost a trust for the benefit of the child/incapable adult. To look upon what is being established as an IHT planning exercise is to miss the point, and will inevitably lead to getting it wrong. That is not to say that consistently with promoting the welfare of the child/benefiting the adult with incapacity it may not be possible to pursue a strategy in settling the trust which will tend to diminish the incidence of capital taxes.

It is suggested that the broad approach to benefit to an adult (and, by analogy, promotion of the welfare of a child) which one finds in the case law under AWISA may be admissible.

AWISA case law suggests "benefit" to an adult with incapacity may result from his property being applied for others as he would have wished or did wish. An example is *M, Applicant*, 2007 S.L.T. (Sh. Ct.) 24, where for the purposes of s.1(1) of AWISA it was found to "benefit" the incapax that *ius relict*i to which he was entitled be renounced in line with what had been his intent whilst he was capable of forming one. Thus, in some circumstances it may be argued that it is acceptable to include trust purposes which favour persons other than the injured person and/or to draw trusts apt to secure favourable IHT treatment consistently with benefit to the injured person in the round.

How do you settle the PIT

For a child?

There is a serious divergence of view in the profession which needs to be resolved

through the courts as to whether a court order is essential to establishing a trust for a child. For the moment there are only arguments and views. Yvonne Evans has suggested in her article "Personal injury trusts: benefits and PIT falls" that a parent as legal representative of a child under the Children (Scotland) Act 1995, s.10, might settle the trust. She says "PITs can be settled by parents, as a child's legal representatives. Under s 10(1)(b) of the Children (Scotland) Act 1995 [CSA], the parent 'shall be entitled to do anything which the child, if of full age and capacity, could do in relation to [the child's] property'."

That is one of two (and there may be more) possible views. In canvassing an alternative, the author would stress that he is not seeking to suggest that he considers Yvonne Evans' view wrong and the alternative right. Hers is a view with which the author has flirted -- and on one occasion rather publicly as a speaker. It is a perfectly respectable view which the writer understands is held and acted upon by members of the profession for whom he has the highest regard. He proposes to canvass the alternative view and the reasoning underpinning it in the second part of this treatment, to be published in a forthcoming issue.

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