Tax Representation

Tax Faculty

TAXREP 27/05

THE MODERNISATION OF THE TAXATION OF TRUSTS

Memorandum submitted in June 2005 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an invitation to comment issued in March 2005 by HM Revenue & Customs.

CONTENTS

THE MODERNISATION OF THE TAXATION OF TRUSTS

INTRODUCTION

1. This submission responds to the third stage of the consultation and amplifies the points we made at the earlier stages and specifically deals with the four topics listed in the consultation document issued on the 16 March 2005 (see http://www.hmrc.gov.uk/trusts/trusts-discussion.pdf). Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex 1 to this document.

2. We would be happy to meet with you to discuss any particular items, as necessary.

3. The scope of the current consultation is limited to the subjects listed in paragraph 4 of the consultation document. However, it is part of the process of the Modernisation of the Taxation of Trusts begun in 2003 and we have some comments on the principles being applied.

4. First, we are in broad agreement with the eleven bullet points on page 5 of the consultation document issued in August 2004. These objectives first appeared in the Overview of the Proposals issued on 17 December 2003. We agree especially with the bullet points that any new measures should 'be clear and easy to operate' and 'the tax system should be as simple and easy to understand as possible'. We feel that the changes to be introduced should be measured against the objectives listed in that document. At present, there is still some way to go to deliver on these promises. In this context we also attach the Tax Faculty's Ten Tenets for a Better Tax System. These are our ten principles that we think should underpin a good tax system. We have set these out in Annex 2 and we would urge you to bear them in mind when designing a tax system for trusts.

5. Trust taxation has become one of the most complicated areas of tax law and in some of the areas which you have highlighted in previous discussion papers there are a number of weaknesses in the existing rules which need to be corrected in any new legislation. The treatment for CGT purposes of the making of a settlement in which the settlor retains an interest and the rules relating to the way trustees expenses are set against income are examples. Some of the complications arise from the treatment in general tax law such as the way dividends and savings income are taxed, but some of the rules appear to lack common sense and the underlying policies, assuming they are still valid, are not obvious.

6. In our response to the August 2004 consultation document (see TAXREP 51/04 at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_71853), we stated the guiding principle of neutrality that a beneficiary of a trust should be no worse off where a trust is involved than if he had received the income or made the gain personally. Trusts with certain exceptions have been singled out as a particular category of taxpayers subject to adverse tax treatment. Where trusts fulfil a useful social need and are not used for tax avoidance there is no justification for unfair treatment.

7. We are pleased that the Government recognises the importance of the role trusts can play in society. They can also be used as an instrument of tax policy to provide a benefit to taxpayers, for example in the area of savings and pensions. However, in general taxpayers no longer expect to achieve a tax benefit from the use of trusts. Where this is the case, we can see no policy reason to impose a more onerous tax regime on trusts.

8. In respect of the tax treatment of different investments, we believe that the tax system should be neutral. A tax system that distorts investment decisions is flawed. However, the treatment of dividends currently creates a clear distortion. In the case of a discretionary trust, the trustees will be under pressure not to invest directly in shares if they intend to distribute all the income because they will have to pay tax on the difference between the Schedule F rate and the rate applicable to trusts. Thus the desired neutrality between receiving income directly and via a trust is not available. This bears heavily on those who are not higher rate taxpayers and thus less likely to invest directly in equities. This is particularly important given that trustees are often seeking to balance the interests of income and capital beneficiaries, and that capital appreciation is more likely to occur with equities than with bonds.

9. The tax system relating to trusts imposes considerable administrative and compliance burdens on both trustees and HMRC. It would be helpful to reduce the number of repayment claims, the number of tax returns and the number of tax payments that are required. Income streaming will help but other changes to the tax system could deliver significant benefits without unacceptable cost to the Exchequer.

INCOME STREAMING

10. We are content in general with the proposal for income streaming referred to in paragraph 8 of the current consultation document. However, we think the time limit should be the same as for filing income tax returns with HMRC: that is 31 January following the tax year.

11. We also agree with the method of calculating each beneficiary's share of streamed income on a pro rata basis. It will produce a proportionate share of each type of income but that should present no problems. Also we assume that this will be on a last in first out basis taking income received in the current year first.

12. The consultation document asks whether income streaming should apply also to deemed income and not just to that which is income under trust law. We have some difficulty in understanding the concept here as trustees will not be able to distribute as income that which under trust law is capital and not income. It would follow that such deemed income is not available to be distributed as income. If it does need to be streamed because it can be distributed then we suggest that it should be treated separately since it will clearly be exceptional. Stock dividends are an example. The tax credit on such deemed income would then pass to beneficiaries in full and it would not be necessary to adopt a pro rata approach.

13. We think that the rules for trust management expenses should be modified if income streaming is brought in. The simplest way of dealing with such expenses is to deduct them on a pro rata basis from trust income. To provide for this section 698B ICTA 1988 will need to be amended.

14. If we understand the proposal for income streaming correctly, a discretionary trust would be taxed in the same way as an interest in possession trust where the income is paid to beneficiaries by 31 December after the tax year in which the income arises. Accordingly the trustees would not be liable to tax at the rate applicable to trusts or at the Schedule F rate that applies to dividends. However, those tax rates would apply to any income not distributed within the time limit.

15. Where trustees make payments to beneficiaries out of income received in earlier years, the trustees' tax liability may be covered in full or in part by tax in the tax pool. If the tax pool is abolished, the trustees will have to pay tax again when the income is distributed in order to provide a tax credit of 40% for the beneficiaries. This is clearly unfair. Retaining the tax pool will enable beneficiaries to access the benefit of offsetting the tax paid in the past against that income when it is distributed in the future. Without this, beneficiaries could suffer very high effective rates of tax on distributions.

16. We see no reason to set a time limit on the tax pool and we think it should be available as long as it is possible to distribute the income as income.

DEFINITION OF A TRUST

17. In paragraph 5.1 of TAXREP 51/04, we said we were pleased that the definition of a settlement in section 43, IHTA 1984 would be the basis for a new common definition of trust for income tax and CGT purposes. Apparently many other respondents agreed. However, the current consultation document says that some concern was expressed about this and that it could create more problems than it solves. It is disappointing that these problems were not more fully described in the consultation paper.

18. The advantage of a common definition arises only if it is based on an existing definition and if it does not create new difficulties. One example is that section 60, TCGA 1992 provides that some property that would otherwise be settled property for CGT purposes is deemed not to be. If, for example, the CGT definition of settlement in section 68 TCGA 1992 is used as the new common definition, it would mean that some trusts that are trusts for income tax would cease to be. It is not clear whether all of these types of issues have been fully considered and the proposal to adopt the IHT definition does not deal with how these types of issues will be resolved.

19. On reflection we are not in favour of a wide spread revision of such fundamental definitions. We think that more detailed consideration should be given to examining the benefits and disadvantages of adopting a common definition.

20. ‘Settlement’ has a number of meanings in law depending on the circumstances. In general it means where someone has settled property upon trust for a beneficiary or a

group of beneficiaries. 'Trust' refers to the terms under which the property is settled. Although there is a distinction between 'trust' and 'settlement', we do not see the need for separate definitions in the tax law.

21. We are not able to express a view about trust law in Scotland and therefore we have no comments on whether separate definitions of 'trust' and 'settlement' would work also in Scotland. No doubt our Scottish colleagues will provide further input on this point. Clearly, however, it would make sense to have a definition that applied both for English Law and Scottish Law.

RESIDENCE TEST FOR TRUSTS

22. We think that in certain cases it may be difficult to ascertain the residence status of a settlor at a particular time. For example it can be difficult to determine whether a settlor is resident in the UK if he has no residence in the UK and no employment and one or more residences overseas. Under current income tax rules, the problem can be dealt with by arranging for all the trustees to be either non-resident or alternatively resident in the UK if a UK resident trust is required.

23. In paragraph 5.5 of TAXREP 51/04, we suggested that a non-resident trust should be able to elect on a year-by-year basis to be treated as UK resident for a tax year. This may help to prevent trusts leaving the UK following the adoption of a single residence definition for both income tax and capital gains tax.

24. The need to protect the competitive position of UK professional trustees has long been recognised for CGT. The right way to harmonise the rules would be to introduce for income tax purposes the special CGT provision that exists for professional trustees in relation to residence. This would make it unnecessary for there to be a separate non-resident trustee. In practice, settlors tend to choose a professional trust corporation to act for them because they have confidence in that organisation. The need to introduce a separate non-resident trustee is an unnecessary and unwelcome complication.

SUB-FUNDS ELECTION

25. Where a person becomes absolutely entitled to property as against trustees as a result of the exercise of a wider form power by the trustees, this is treated as a disposal for CGT. If a new trust is created it would be regarded as separate settlement. However, following *Bond (HMIT) v Pickford* [1983] STC 517 and the subsequent Inland Revenue Statement of Practice (SP 7/84), it is possible for trustees to exercise a power of appointment or advancement whereby property is transferred to other trustees but remains to some extent subject to the terms of the original settlement. In those circumstances, there is no deemed disposal for CGT purposes by the original trustees. It is possible for trustees to create sub-funds so that the trust property is still subject to the original settlement but new trustees are appointed to the sub-funds.

26. Where there are sub-funds at present the trustees need to deal with apportioning the CGT liability and that already extends to the use of the annual exemption and losses and all of the other points mentioned in paragraph 22. We suggest, therefore, that

there is no need for the legislation to specify what needs to happen in these circumstances as the trustees will be able to deal with it.

27. In relation to sub-funds what is suggested is simply an election for tax purposes that a sub-fund should be treated as though it were a separate settlement not a disposal of the trust assets. The assets would continue to be subject to the original settlement

28. There are often good practical and administrative reasons why trustees want to set up sub-funds. A sub-funds election would enable the taxation affairs of the trustee to be separated more easily in relation to each sub-fund. The definition of a sub-fund should be where, if no new trustees are appointed, there is a separation of trust property and income as between beneficiaries or groups of beneficiaries. Additionally a sub-funds election should be allowed where different trustees are appointed to administer property still subject to the terms of the original settlement.

29. Since the policy purpose of a sub-fund election will be to ease administration and compliance burdens for both taxpayers and HMRC, it would help to make the election as flexible as possible. That being so, we do not think that there is a policy reason to make it irrevocable. Indeed, there may be circumstances where the property ceased to be comprised in the sub-fund and reverted to the main trust fund, in which case it would be easier for all concerned for the election to be revoked.

30. In order to ensure that the election is as flexible as possible, we think that the proposed election should be available to one or more sub-funds and what settled property is left would be dealt with as the original trust (which might include sub-funds that had not elected for such treatment).

31. The disposition of assets to a sub-fund would not be treated as a disposal for CGT. Accordingly we do not see the need for any changes to the CGT legislation. Indeed, if a sub-funds election were to be regarded as a disposal for CGT purposes it would ensure that most trustees could not contemplate making this election as it would result in a CGT liability. It would be contrary to the purpose of the whole consultation process on the modernisation of trusts to introduce such new charges.

KM
10.06.2005

ANNEX 1

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members and students, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

ANNEX 2

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160.