Tax Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 51/04
(CIOT ref: TDP 115/04)

MODERNISING THE TAX SYSTEM FOR TRUSTS

Text of a memorandum submitted in October 2004 jointly by the Tax Faculty of the Institute of Chartered Accountants in England and Wales and The Chartered Institute of Taxation in response to an invitation to comment issued in August 2004 by the Inland Revenue

CONTENTS

MODERNISING THE TAX SYSTEM FOR TRUSTS

This submission responds to the second stage of the consultation and amplifies the points we made at the first stage. We are pleased that many of the points made by us and the other professional bodies have been taken on board. Our comments follow the headings in the August 2004 Consultation Document. (see http://www.inlandrevenue.gov.uk/trusts/trusts-modernisation.pdf)

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

1. INTRODUCTION

1.1 We are glad to note that the Government recognises the importance of the role trusts can play in society. As far as possible, we would support its desire for a tax system for trusts that does not provide artificial incentives to set up a trust, but equally avoids artificial obstacles to using trusts where they would bring significant non-tax benefits. We note that the Government does not want a system that enables people to use trusts to avoid tax; equally, as far as possible, it does not want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as the laws of intestacy. Nor does it want to penalise beneficiaries where a trust exists to protect the most vulnerable such as disabled persons.

1.2 However, this is narrower than avoiding artificial obstacles to using trusts. Surely the tax system should not penalise beneficiaries wherever a trust is employed, whatever their status? This does not necessarily mean that the rules should always be the same. Nevertheless, the principle should be that a beneficiary should be no worse off where a trust is involved than if he had received the income or made the gain personally. We believe there are areas where the proposed changes fail to achieve this neutrality. Today's taxpayers do not expect to achieve a tax benefit from the use of trusts but we do not see any justification for a penalty. Beneficiaries who are not settlors have trusts imposed upon them and do not themselves set up a trust in order to try to achieve a tax benefit.

2. TRUSTS FOR THE MOST VULNERABLE

Election system

2.1 We agree in principle that, following an election, trusts for vulnerable beneficiaries, ie those who are disabled or lose a parent before the age of 18, should be taxed on the basis of the beneficiary's individual circumstances. It is implicit that this tax treatment is to apply to income arising, regardless of whether it is accumulated or distributed.

2.2 However, we fail to see the need for the terms of the trust deed to give an unconditional entitlement to any assets in the trust at the age of 18. No responsible parent with any thought of the welfare of his children would set up a trust which in the event of his death would give outright entitlement to the capital in the trust to his children at the age of 18.

2.3 We suggest that the IHTA 1984 s71 test for an accumulation and maintenance settlement (requiring, broadly that an interest in possession be attained by age 25) would be more appropriate, and should apply to all trusts for young people (not only those set up by parents under Will or intestacy). The s71 IHTA test is well understood and works well in practice.

2.4 Alternatively, we strongly believe that, at the very least, the beneficial tax rules should apply up to the age at 18 without there being any requirement that the trust capital must then pass to the beneficiary.

2.5 We agree in principle that property which is held for vulnerable beneficiaries under a benign tax regime should be ring-fenced; however, we consider that for disabled beneficiaries the accumulation period should continue unless the disability ceases, as it may not be appropriate for the disabled person to be entitled to all the income, as this may create problems with inheritance tax and state benefits, etc.

Tax effects of election

2.6 We assume that the reference to CGT settlor-interested trusts (implying that the beneficiary will be deemed to be the settlor for CGT purposes so that the look-through provisions in TCGA 1992 s77 would apply) would be redundant if, contrary to our suggestions, a streamed approach to capital gains is rejected..

2.7 The effects of an election do not appear to have been completely thought through. If income is to be treated as that of the beneficiary, then it has to be included in his personal return (and taxed accordingly). This is superficially attractive, but difficulties arise with tax repayments, which necessarily would be made to the individual. We suggest that the trustees be given a statutory right of recovery or the SA Return repayment boxes be altered to permit such repayment direct to the trustees. Provided that the trustees have supplied the appropriate information to the individual, they should not have any ongoing liability for its disclosure to the Revenue.

2.8 On the other hand, if the trustees are to be assessed on trust income but with the benefit of the individual beneficiary's personal allowance and tax bands, they will have to have details of his other income (if any) and allowances available. Although the concept of a joint election would indicate co-operation between the beneficiary, his carers and the trustees, that election may well have been made many years earlier. Therefore we believe that giving the trustees a statutory right to information is essential in this case. On balance, we would prefer to operate the system outlined in this paragraph, where trust income is returned by the trustees, rather than it being returned by the beneficiary.

2.9 The proposal is that the election should be irrevocable. We suggest that it should be revocable – once. This would allow for circumstances such as breakdown in relationships and the supply of information between trustees and beneficiary.

Interest in possession trusts

2.10 In principle, we agree that a similar, streamlined system would be appropriate for interest in possession trusts for vulnerable beneficiaries.

Time limit for elections

2.11 We agree that, for new trusts, the election should normally be made when submitting Form 41G. However, in many cases, particularly on intestacy, the family may not immediately recognise the need to register trust details, or to file returns. When they do so, they should not be denied the benefits of this regime. We agree that it would be fairer to leave a window within which the election could be made. Two years from the parties making their decision lacks precision. We suggest a practical solution would be for an election to apply for the income of any tax year, provided it is made by 31 January following the end of a tax year in which the return is submitted.

2.12 Given the scale of changes to trust taxation generally, the proposal to limit the ability of existing trusts to elect for the new regime by 5 April 2006 is unduly restrictive. It goes counter to the policy objective affording special treatment to trusts for the vulnerable. Either the standard 2-year limit should apply as normal, or the flexible limit that we suggest above.

Other Issues

2.13 The Master of the Court of Protection, Solicitors for the Elderly and others working with the vulnerable are concerned about financial abuse of the elderly. The voluntary trust is one of the best ways of protecting such people; it offers the ability to spend capital that is not permitted under a receivership without a court order, and is not subject to the restrictions of an EPA.

2.14 Under current tax legislation the potentially vulnerable are prevented from transferring their assets to such a trust, because the gift gives rise to a deemed disposal on which CGT is payable. This is notwithstanding the fact that trust gains are assessed on the settlor-beneficiary. We believe that there is no justification for this: it seems unreasonable and could be doing real harm.

2.15 For example, consider the position of someone who has recently been diagnosed with a particularly aggressive form of Parkinsons disease which is affecting his brain rather faster than his body. He still has testamentary capacity, but is aware that he may not have it for much longer. The voluntary settlement would have been a good way of managing his finances, but the cost of a CGT disposal prevents it.

3. BASIC RATE BAND

3.1 We welcome the proposals as being fair, clear and easy to operate. They should improve compliance and reduce the burden on smaller trusts.

Other Issues

3.2 It is generally accepted that the Accrued Income Scheme does not fit easily with self-assessment, and imposes an unnecessary compliance burden on many small and moderately sized trusts. In particular, there is currently no trust equivalent to the £5,000 threshold applying to individuals. It has been suggested that applying a similar threshold for trusts "would enable the AIS rules to be circumvented by fragmentation of holdings between a number of trusts". We think that the simple and well-understood "anti-fragmentation" measure that already applies for CGT could be similarly applied to AIS.

4. **INCOME STREAMING**

4.1 We are reasonably happy with the income streaming proposals, apart from stock dividends. This, together with the proposal to charge capital gains paid by the trustees at the RAT, is a major distorting feature of these proposals. We would like to see amendment by way of a capital profits pool (outlined below).

Time limits

4.2 We are happy with the proposed time limit for distributions to avoid the RAT as being 31 December following the end of the tax year; the potential mismatch between the amount of tax that would have been due in the year the income arose and the amount actually due in the year it is received by the beneficiary is an inevitable, yet acceptable consequence of adopting a realistic approach to the problem.

4.3 We note the need to counter the potential for income being passed from one trust to another in order to defer RAT. Any anti-avoidance rules must be targeted, specific and proportionate. We would not support any provisions that rendered the trustees liable for what the beneficiaries may (or may not) do: such matters would be beyond the trustees' control.

4.4 We suggest that, to ease compliance for trusts that do not submit SA Returns, the notification by 31 December should follow the format of R185s which would have had to have been completed for the beneficiaries in any event.

Tracking income through the trust

4.5 We agree with the proposals for tracking income. To treat the income streamed to a beneficiary as a mixed payment of a proportionate share of each type of income that has arisen to the trustees in the year in question seems a sensible and pragmatic approach.

The tax pool

4.6 We do not accept that tax pools are "difficult to understand" and "complicated to operate". If tax pools are abolished now, or possibly as suggested after three years, taxpayers will never be able to get the benefit of offsetting the tax paid in the past against income distributed in future. The proposal to abolish tax pools is completely one-sided: any benefit favours the Revenue and is detrimental to the beneficiaries. This is even more the case with the increase in the RAT to 40%.

4.7 In many trusts, if they are to achieve their purpose, it is not possible for the trustees to distribute the whole of the income. In particular, in maintenance and accumulation settlements the intention is to accumulate income other than that needed for the maintenance, benefit and education of the beneficiary. That would indeed be the case while the beneficiaries are very young. RAT has in the past applied to, and would in the future continue to apply to, such income and should go into the tax pool. As and when further distributions are made, the beneficiary ought to have the benefit of the tax credit. This means that, if the beneficiary's tax charge on receipt of the income distribution is less than the RAT, he should be entitled to a refund of tax.

4.8 This also preserves the tax neutrality of the trust so far as possible and gives the Revenue the cash flow advantage of the RAT since many beneficiaries would have a much lower tax liability had the income been distributed to them as it arose.

4.9 We are therefore strongly against the proposal to abolish the tax pool: this would make the taxation of trusts penal compared with receipt by the beneficiaries, and would run counter to the guiding principles of the Consultation that, where a beneficiary receives income or benefits from a trust, he should where possible be taxed as if he had received them direct.

Transitional issues

4.10 Transitional issues would not arise if the pool were kept. If, despite our concerns, the tax pool is abolished, we concede that retention of a frozen pool is the least bad solution.

4.11 However, a transitional period of merely 3 years is far too brief. It would force trustees to make payments for tax reasons rather than in the interest of the beneficiaries, particularly in the case of long running accumulation and maintenance settlements identified above.

Non-resident aspects

4.12 We welcome the proposal to exempt from RAT streamed income paid from a UK resident trust to non-resident beneficiaries. We repeat our concern that any anti-avoidance provisions be carefully targeted at the perceived mischief.

Gains streaming

4.13 We are disappointed that our concerns expressed at earlier stages of the consultation have been overlooked. We do not think that the suggestion to stream rapidly distributed gains is the only solution. We suggest below the possibility of a gains pool that would give some relief on distributions without requiring the trustees to distribute within a specified period to the detriment of the trust objects.

4.14 We refer again to the guiding principles that are supposed to apply to the modernisation of trusts. We maintain that it is neither fair nor reasonable to charge the full 40% RAT on trust gains when the beneficiaries would pay at the savings rate or zero had they made the gain personally. Complexity does not seem to be a problem where anti-avoidance is concerned; for one example see FA 2004 Schedule 4. It is not acceptable for the Revenue to go against their own guiding principles purely for the sake of simplicity and in the process penalise beneficiaries. This is a distorting feature that our proposals for a capital pool (below) address. We are also concerned that it appears that the RAT will apply to lease premiums and gains under TA 1988 s776, which currently suffer only the basic rate.

Suggestions for a capital gains pool

4.15 We suggest an alternative approach. As and when capital profits are distributed to a beneficiary, tax should be charged on the beneficiary at the higher of the rate of tax which he would have been charged had he made the capital profit or gain in the year in which it is distributed or, to prevent manipulation for tax avoidance purposes, the average rate of tax that he would have suffered had the gain been distributed in the year in which it is distributed and in the previous four years, so that there is a five-year average of the tax charge. A repayable tax credit equal to the proportion of the CGT pool that the capital distribution bears to accumulated trust gains would offset the beneficiary's personal liability.

4.16 We believe that this would, without excessive complexity, produce an equitable solution, which reflects the fact that many beneficiaries to whom capital profits and gains would be ultimately distributed are not liable to tax at the higher rate. We think that the absence of any streaming provisions gives rise to potential distortion. However, we would not want a situation where the trustees have to distribute capital in order to avoid RAT on capital profits and gains, as this would in many instances defeat the family protection reasons which may have led to the trust being set up in the first instance.

5. DEFINITIONS AND TESTS

5.1 We are pleased that the IHTA 1984 s43 definition of a settlement is to be the basis for the new common definition of trust for income tax and CGT purposes. We are also in broad agreement with trustees being regarded as a single and continuing body of persons, as under TCGA 1992 s69 (1). The suggested provisions in relation to bare trusts and settlor-interested trusts do not give rise to any new problems.

Residence test

5.2 We do not agree that the test for residence should be based on the current income tax rules.

5.3 The Consultation Document assumes that trusts have individuals as trustees but, in view of the liability of trustees, we suggest that many trusts have corporate trustees with limited liability. Therefore, the income tax test proposed at 4.33 would mean that, if the trustee were a UK trust company, the trust would become resident in the UK for CGT purposes. The fact that it is resident in the UK for income tax purposes under the current law is not normally a problem where the beneficiary, as is often the case, is resident in the UK with an interest in possession and therefore entitled to the income as it arises anyway.

5.4 We prefer the CGT definition in TCGA 1992 s69 rather than the income tax definition proposed. Our main reason is that the CGT definition allows UK resident professional trustees to be treated as non-resident where the settlor is non-UK domiciled, resident or ordinarily resident under TCGA 1992 s69(2). Under these provisions many such trusts are run from the UK. As is pointed out at 4.34, the management of such trusts could be transferred offshore, but this would result in additional costs and inconvenience for clients, and the UK loses the benefit of UK tax on the fees and tax paid by employees doing the work in the UK.

5.5 We think that any non-UK resident trust should be able to elect for income tax (and we see no reason why the election should not be extended also to capital gains tax, separately) to be treated as if it were UK resident. We believe a good case can be made for this flexibility. Many trusts are of mixed residence in that they are UK resident for income tax (by virtue of having a UK settlor and one UK resident trustee) but are non-UK resident for capital gains tax. On a harmonised definition (whatever it is), these trusts need to retain their non-UK resident status for capital gains tax, and therefore will need to become non-UK resident for income tax. That will have a cost to the Exchequer, because many of these trusts are not settlor-interested and therefore non-UK source income will escape any immediate liability to income tax. The trustees have preferred to pay income tax on all income in order to avoid the complications and uncertainties of TA 1988 s740. Allowing non-UK resident trusts to elect on a year-by-year basis to be treated as if they were UK resident for income tax can only benefit the Exchequer if the election is made.

Professional Trustees

5.6 As stated above, we would not have thought that retaining this provision is anything other than in the interests of UK professional trustees and the UK economy, which is why the provision was enacted in the first place. The proposal to remove it is unreasonable and ignores the competitiveness of this sector in the UK economy.

Transitional issues

5.7 There are two ways in which a trust can be presently of “mixed residence”. A trust could either presently be UK resident for income tax but non-UK resident for capital gains tax, or non-UK resident for income tax but UK resident for capital gains tax.

5.8 The consultation document refers to a transitional period of 12 months for mixed residence trusts that are UK resident for income tax but non-UK resident for capital gains tax.

5.9 The consultation document does not deal with any transitional period for the other type of mixed residence trust which is non-UK resident for income tax and UK resident for capital gains tax. This sort of mixed residence trust is in need of a transitional period if the income tax definition is to be adopted, because otherwise a capital gains tax exit charge arises as a result of inaction taken by the trustees.

5.10 We contend that, since there is no compelling reason to prefer the income tax test to the capital gains tax test for residence of a trust, and as we believe the proposal is based on a misconception that personal trustees are the norm, it should not be implemented.

6. CHARGEABLE GAINS OF ESTATES

6.1 In cases where an assent is not possible, we prefer the suggested solution that personal representatives be allowed to make an election to be treated as though the asset disposed of had been transferred to the estate beneficiary or beneficiaries immediately before the disposal, similar to an election under TCGA 1992 s171A.

6.2 We do not, however, object to the proposal to charge personal representatives CGT at 20% up to a capped limit in the year of death and the following two years, provided that the cap is at a reasonable level, say, gains of £100,000. Please confirm that the intention is for a 20% band, and not a "slab" approach like SDLT where, if gains exceed the threshold, all would be subject to RAT.

7. OTHER OPTIONS FOR CHANGE

Sub-funds election

7.1 We welcome the proposal made by our colleagues at STEP that trusts where assets have been split off into separate sub-funds administered by different groups of trustees should be able to elect to be treated as separate trusts for all income tax and CGT purposes. We agree that an irrevocable election by the trustees to be treated as entirely separate entities for tax purposes would offer real administrative benefits.

7.2 We find it difficult to believe that such provisions would be exploited for the sake of a basic rate band of £500, which provides an advantage of all of £90 a year or for an annual exemption for CGT, which would presumably still be covered by the anti-avoidance provisions in Schedule 1 TCGA. This allows a maximum benefit of £328 per year. We think that the proposal should be adopted as it stands, and there is no need for anything further to prevent abuse.

Income of settlor-interested trusts

7.3 We support the suggestion that, instead of a charge under Case VI of Schedule D, income from settlor-interested trusts would be assessable as though it had arisen directly to the individual. This proposal is in line with the objectives of fairness and transparency.

Capital items subject to income tax

7.4 We commented earlier on capital items subject to income tax, where we think there should be a pooling mechanism as we would suggest for capital gains.

Chargeable gains of settlors

7.5 We are disappointed that it has not been thought reasonable that, where the settlor is being assessed on the trust gains as if they were his own, he should be allowed loss relief on the same basis: all gains, less losses of his own and those of the trust deemed to be his, would be taxed or allowed.

7.6 We cannot see why complex rules would be needed. It does not seem to us to be abusive to allow the settlor's actual gains and losses to be merged with those that are deemed to be his in order to calculate the net gain or loss.

7.7 We therefore disagree with the conclusion not to take this proposal forward.

7.8 We are also concerned that, if the settlor interested trust provisions are introduced into capital gains tax, a gift into a bare trust for minor children would give rise to a capital gains tax charge as a disposal by the donor, but subsequent gains would still be taxable on him as settlor, which seems unreasonable. A transfer into trust should be ignored for CGT purposes where any actual gains remain taxable on the transferor; our comments at 2.14 apply in such cases.

The Chartered Institute of Taxation
The ICAEW Tax Faculty
19 October 2004