

TAXREP 23/06

TRUSTS MODERNISATION

TAX LAW REWRITE: BILL 4

Memorandum submitted in August 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an invitation to comment issued in July 2006 by HMRC Tax Law Rewrite Team

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TRUSTS MODERNISATION

TAX LAW REWRITE: BILL 4: PAPER CC(06)09

INTRODUCTION

1. We welcome the opportunity to comment on Paper CC(06)09 published on 7 July 2006 by HMRC's Tax Law Rewrite team at <http://www.hmrc.gov.uk/rewrite/exposure/menu.htm#2>.
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

GENERAL COMMENTS

3. We note that work continues on the draft clauses in Paper CC(06)09 in the light of the responses received on the draft Income Tax Bill ("Bill 4") as published in February 2006.
4. We do believe that that in the interests of clarity several ESCs should be enacted and we have reservations regarding the treatment of trustees' expenses between discretionary and IIP trusts. Subject to that and to other matters covered below, we are content with the draft clauses as rewritten.

ANSWERS TO QUESTIONS

5. **Q1** We are content with the way that exemptions from the charge at the special trust rates have been dealt with in sub-clauses 22(1) (exemption for charitable trusts); (5)(a) and (b), relating to accumulated or discretionary income (or such income apart from Paper CC(06)09 clause 21(3)); and (5)(c) and (6) (certain income arising to certain pension funds).
6. **Q2** We support as a simplification measure the inclusion of the amounts taxed on trustees under the accrued income scheme, in clause 23 (and hence referred to in clause 22 (Other receipts of trustees to be charged at special rates)) as amount Type 2).

SPECIFIC COMMENTS ON DRAFT LEGISLATION

cl 5 Overview of Part

7. Would it not be more sensible to include the provisions on trusts with vulnerable beneficiaries at this point, rather than leaving them in FA 2005?

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cl 6 Interpretation of Part

8. We would welcome clarification of the aim here. It may be to define a phrase ("trust rate income") that does not incorporate interest in possession (IIP) trusts. If so (and we are not sure why such a definition is needed) it would seem to bring within its scope those IIPs which have a trust rate liability on their AIS, etc. income. This may well not occur every year, so IIP trustees may find themselves within the definition some years and not in others. We assume that this is unintended and suggest that the wording be clarified.

cl 9 Meaning of "settled property" etc

9. **(3)(b)** We assume that this is intended to cover jointly-owned property (among other situations) as, technically, all jointly-owned property is held in trust for the joint owners. We are concerned that it only refers to "for another person", and not also "any person, including the trustee himself". We would welcome confirmation that this does not unintentionally mean that part of the joint property, namely the part held for the trustee himself, is back within cl 9(2).
10. **(3)(c)** In Explanatory Notes paragraph 9, the reference to section "685D(3) of ICTA" should, in the context of clause 9, be to section "685A(1)(a)(iii)". We note the replacement of the words "under a disability" by "lacking legal capacity"; and similarly in clause 15(3)(d).
11. **(5)** Should sub-clause 9(5) be redrafted to refer to references to a person who is *or would be* absolutely entitled to property as against the trustees, in accordance with the source legislation in s 685A(2) ICTA?

cl 10 Meaning of "settlor" etc

12. **(1)** We question the vires of this clause as following *IRC v Plummer*, we thought that there also had to be an element of "bounty" in defining a settlement and, hence, settlor.
13. **(8)** We suggest that the wording be tightened up to confirm what "those sections" means: we assume that it refers to sections 12 to 16, as set out in cl.10(7)

cl 13 Transfers between settlements

14. **(2)(a)** Will "assignment" be defined for the purposes of clause 13 to include "assignation" elsewhere in Bill 4, in accordance with s 685C(6)(a) ICTA?
15. **(3)** Why have the words "and a reference to transferred property is a reference to property acquired by the trustees of Settlement 2 on the disposal" in s 685C(2) ICTA not been rewritten in clause 13(3)?
16. **(3) and (4)** (3) defines "transfer of property" and then (4) redefines the essential parts of "transfer of property" by reference to a different Act. We wonder what is the point of having both these sub-clauses.

cl 15 Settlor where property becomes settled because of variation of will etc

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17. (4) In the penultimate line, grammatically we think that "treat" should be "treats" as the subject is singular, ie "legatee", not plural.

cl. 21 Meaning of “accumulated or discretionary income”

18. Section 624(1) ITTOIA provides that income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises during the life of the settlor from property in which the settlor has an interest. This means that such income cannot be taxed as the income of trustees of a discretionary trust. However, FA 2006 Schedule 13 para 2 amended section 686(2)(b) ICTA1988 to remove a provision which seemed to make it clear that the trustees do not pay tax at the trust rate in a settlor-interested trust. It appears that clause 21(3)(a) seems to link through with Section 624(1) so that the trustees do not have to pay tax on such income at special rates, but it would be helpful both to clarify this and that the trustees do not have to pay tax at any other rates since the income is treated for all purposes as that of the settlor.

cl 22 Other receipts of trustees to be charged at special rates

19. (6) Is this duplicated by 22(5)(b)'s referral to 21(3)(b)?

cl 24 Sums paid by personal representatives to trustees

20. (2)(b) "Applicable rate" is referred by (3) to ITTOIA 2005 s.663(1). We would welcome clarification of whether the rate is the rate of the year of payment by PRs to trustees or the rate of the year in which the income arose to the PRs.

cl 25 Trustees expenses to be set against trustees' trust rate income

21. (1) We are disappointed that the clause uses the word "pay", rather than "suffer", etc. We would prefer accruals to be the basis, which would be consistent with accounting treatment for tax purposes generally. (See also re cl 41(1)(a), below.)
22. (5)(b) We would welcome confirmation that this does reflect the current position.

cl 26. Income expenses paid out of capital

23. This phraseology of this clause does seem an extraordinarily clumsy way of stating that an excess of expenses over income can be carried forward to the next year.

cl 28 Non-UK resident trustees

24. (4)(b) We assume that the label “double taxation arrangements” will be defined elsewhere in draft Bill 4. In draft Bill 4 (February 2006) it was defined in clause 470(4)(b) as “arrangements having effect by virtue of section 788 of ICTA”.

cl 32 Special rates not to apply to first slice of trustees' trust rate income

25. (4) The basic rate band is applied in reverse order from the set off of expenses.
26. (5) We note the appropriate inclusion now of clause 32(5), as cross-referencing to clause 25(3).

cl 34 Discretionary payments by trustees

27. (2) This seems to be at least a partial enactment of ESC A68. We recommend that the whole of A68 be enacted rather than leaving some of it as an ESC.

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28. **cl. 35 Grossing up of discretionary payment and payment of income tax**
Section 685A ITTOIA 2005 provides that where a person receives an annual payment under the exercise of the discretion of the trustees and a settlor is charged to tax under section 619(1) on the income of the trustees, then the recipient of the annual payment is treated as having paid income tax at the higher rate in respect of the annual payment. It would be helpful to include this in a new clause after clause 35 so that all the provisions relating to discretionary payments are kept together. It is also necessary because the trustees do not have to apply the income tax charging provisions of proposed section 37 in respect of such a payment
29. **cl 38 Calculation of trustees' tax pool**
(1) Step 1 refers to income of the current year. Step 2 refers to the tax pool brought forward and then deducts tax attributable to payments to beneficiaries in the *previous* (our italics) tax year. Why the "previous"? That tax will have been taken into account in calculating the tax pool brought forward, so this will deduct it twice. Also, should there not be a deduction for the tax attributable to payments to beneficiaries in the *present* tax year?
30. Explanatory Note 82 does not give us comfort on this point.
31. Also, can we would welcome confirmation that this will produce a truly cumulative position, and not that only the previous year's tax position is brought forward.
32. This clause seems not to allow for the present position, that non-resident trustees can (if they wish) opt into the U.K. tax regime for trust rate purposes. Given that Explanatory Note 70 says that it is intended that this continues to be covered by ESC B18, we consider that this concession should be enacted; also because it is very difficult in practice to understand without experience the way that HMRC apply it.
33. **cl 39 Types of income tax for the purpose of section 38**
(1) Type 2 seems still not to include life policy gains..
34. **cl 41 Restrictions on use of trustees' expenses to reduce the beneficiary's income**
(1)(a) We note that here, the reference is to expenses "incurred", as opposed to "paid", which is in contrast with see cl 25(1) above. Having different approaches is unnecessarily confusing for mixed trusts, for example where one fund is discretionary and another is IIP. This is going to be much more of a problem for 2007 and subsequent returns, than it has been up to 2006, following the importation into income tax of the "one trust" concept from CGT.
35. **(2) and (3)**. (2) allows expenses chargeable to Income by the terms of the Deed but then disallows expenses if they are outside the general law interpretation of "income expenses". (3) seems to be self-cancelling. Sub-section (3)(a) allows expenses, as under general trust law, even if they are not deducted from income because of a specific provision in the Deed but (3)(b) then reinforces the general law point but specifically disallows expenses disallowed by the terms of the Deed. We may be missing a question of legal construction of the wording here but, to us non-lawyers, it seems contradictory.

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cl 44 Meaning of “untaxed income”

36. We suggest adding to the heading "for section 43". Otherwise, it might be thought that the definition is for all tax purposes. Whilst we appreciate that section headings are not operative as part of the legislation itself, we think that it would help clarify what it refers to.
37. **(1)(b)** We assume that the label “double taxation arrangements” will be defined elsewhere in draft Bill 4. In draft Bill 4 (February 2006) it was defined in clause 485(1)(b) as “arrangements having effect by virtue of section 788 of ICTA”.

cl 45 How beneficiaries’ income is reduced

38. **(4)** The calculation steps here are made on a net basis (for IIP trusts) but in cl 27(1) (for discretionary, etc. trusts) on a gross basis. We suggest that for discretionary trusts it is easier to work on a net basis, as this saves having to gross up expenses at different rates, depending on the nature and amount of the original income and when each type of income is absorbed by expenses.

cl 47 Treatment of income of unauthorised unit trust

39. **(3)** It seems most odd that this clause charges dividend and savings income to basic rate, instead of dividend or savings rate, as appropriate.
40. We note that the predecessor sub-clause 488(5) in draft Bill 4 (February 2006), which signposted certain further exceptions relating to unauthorised unit trusts in ICTA and ITTOIA, has now been dropped from clause 47. Is there a reason for this?

cl 49 Special rules for trustees affected by section 733 of ICTA

41. Why has draft Bill 4 sub-clause 490(4) (Special rules for trustees affected by section 733 of ICTA), which applied clause 490 before working out the result of clause 489(7) (Relief for trustees of unauthorised unit trust), not been rewritten in clause 49? Is subjecting s 48 to s 49 in clause 48(4) considered sufficient?

cl 50 Residence of trustees

42. Is it intended to rewrite s 685E(9) ICTA?

cl 52 Meaning of “connected” persons

43. **(4)** Why are the references now to “partnership” rather than to “firm”?

TJH/PCB
25.8.06

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ANNEX

WHO WE ARE

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.

The 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, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

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.

To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at tdtf@icaew.co.uk or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

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.