

TAXREP 7/06

MODERNISATION OF THE TAXATION OF TRUSTS

Memorandum submitted in February 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to HM Revenue & Customs in response to an invitation to comment on draft legislation published with explanatory notes on 31 January 2006.

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MODERNISATION OF THE TAXATION OF TRUSTS

INTRODUCTION

1. We are pleased to respond to the invitation to comment on draft legislation published by HM Revenue & Customs (HMRC) on 31 January 2006. The press release, draft legislation and related documents can be found at <http://www.hmrc.gov.uk/trusts/mod-tax-system-trusts.htm>.
2. The ICAEW Tax Faculty has participated in the consultations which have been taking place on the modernisation of the taxation treatment of trusts. The consultations and the process of modernising the tax law relating to trusts has taken a number of years and is not yet complete. But given the importance of trusts and their value to the public in managing wealth, transferring assets, and providing for others the exercise is worthwhile. There is potential for simplifying the treatment of trusts, for assisting trustees in the administration of their taxation responsibilities and for reducing the cost of collecting the tax for HMRC. So far this has been a collaborative process but a number of factors are putting at risk the continued co-operation of those involved in the consultation process. Our concerns are explained below.
3. Details about the Tax Faculty and the Institute of Chartered Accountants in England and Wales are set out in Annex A.

KEY POINT SUMMARY

4. Our key concerns are:
 - There are strong grounds for postponing for one year the introduction of the new legislation to allow time for proper consideration and comment.
 - The overriding perceived need to counter avoidance is standing in the way of practical reforms that could assist trustees and HMRC in equal measure.
 - The explanatory notes paraphrase but do not explain.
 - Opportunities for simplification are being lost in new complexities some of which have no apparent purpose.
 - Provisions designed to be trade facilitation measures are spoiled by an excess of bureaucracy which may damage an important service industry.
 - The legislative process and some of the draft provisions breach several of the Tax Faculty's *Ten Tenets for a Better Tax System* which we use as a benchmark and which are attached at Annex B.

GENERAL COMMENTS

5. We were told to expect the draft legislation in the autumn of last year. The complexity and importance of the subject excuses the slippage of time but we are disappointed that we were only given just over two weeks to comment on the very lengthy draft provisions. Clearly it is better to expose the draft legislation to comment with a short deadline than not at all. However, to allow such a short period damages goodwill and suggests that comments are not valued. We recommend that

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implementation of the new provisions be postponed for a year to allow proper time for consideration and comment from tax practitioners.

6. The need to counter avoidance appears to have become an obsession in relation to trusts. There appears to be a view in HMRC that trusts are synonymous with avoidance. That attitude is standing in the way of practical reforms that could assist both trustees and HMRC.
7. We are greatly disappointed with the explanatory notes. They paraphrase the draft legislation but what they do not do is explain. Those who read the notes hoping to find the reason for the introduction of particular provisions, the intention and purpose of the provisions and background to give some understanding of the problem will be greatly disappointed. They fall below the standard expected for such notes. Our legislators need to be informed of the intended purpose of the legislation in simple terms if there is to be proper parliamentary scrutiny.
8. Opportunities for simplification are being lost in what we can only describe as a blizzard of new complexities some of which have no apparent purpose. If we were asked to point out new measures which will make life simpler for trustees or their advisers or to provisions that will improve the collection of tax we would have difficulty finding examples. More detail on this point is given below.
9. The professionals who provide services to overseas trusts are a significant part of a service industry that is of value to the UK economy. It is generally recognised that the tax system should not make it difficult or impossible to win this type of work for the UK (see Tenet 10 in Annex B). The draft legislation contains provisions along these lines which are trade facilitation measures. Unfortunately they are spoiled by an excess of bureaucracy which may actually discourage overseas settlers from appointing UK trustees. This issue is explored more fully below.

DETAILED COMMENTS

Schedule 2

10. **Paragraph 1(1) - 685A Meaning of “settled property.”** Paragraph 4 of the explanatory notes does not begin to explain what is really happening here. We assume that from 6 April 2006 trustees of certain trusts will no longer be chargeable to income tax and the beneficiaries will be chargeable directly instead. However, if we are wrong we should be grateful for details of the effect of the change.
11. **Paragraph 1(1) – 685B Meaning of “settlor.”** We can see that a person ceases to be a settlor once the property which he settled ceases to exist. However, we would welcome more explanation of the effect of the changes to this section. The introduction of the new test in sub-section (6)(a) will require new rules to determine what property has left the settlement if there is more than one settlor. We are not sure how you intend to deal with cash for example.
12. **Paragraph 1(1) – 685C Transfer between settlements.** It would be helpful to have a provision which specifically requires that where there is more than one settlor then

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there is more than one settlement: similar to section 44(2) IHTA 1984. This is required to make sub-paragraph 3 work effectively in a case where for example A and B have each settled property on a trust for their respective grandchildren. The trustees then appoint the funds provided by B onto a new trust created by C. B should be treated as the settlor of this appointment and not A.

13. In relation to the change in new section 685C we point out that explanatory note 7 of the income tax notes and paragraphs 14 to 17 of the capital gains notes do not really describe why it is needed. They do not describe the effect of the change in plain English.
14. **Paragraph 1(1) – 685D Variation of will or intestacy: identification of settlor.** We would welcome clarification that sub-paragraph (3) does not include the situation where a person becomes entitled to a life interest as a result of the will, since this does not seem to fall within sub-paragraph (2). The explanatory notes refer to someone having an interest in the property before the variation which is unclear.
15. We should be grateful for confirmation that nothing in the revised section 685D affects the decision in *Marshall v Kerr* [1994] STC 638.
16. In revised section 685D (5)(b) we are confused by the words “except where the context otherwise requires.” We would welcome clarification of what this is meant to convey.
17. Please confirm that in a case where A dies leaving a property in his will to B for life and then to C, and B creates a trust for his family and varies the will to pass into that trust the property he has been left by A, that A is the settlor of this trust and not B.
18. We understand the desire to harmonise the rules in order to simplify but feel that new complications are being added.
19. **Paragraph 3(1) – 686A Receipts to be treated as income to which section 686 applies.** We have some doubts about the effectiveness of the drafting here. It seems to us that the wording in section 686A (3) works better as a deeming provision.
20. **Paragraph 4(2) – 686E Application of section 686D where settlor has made more than one settlement.** We strongly recommend that this provision should be deleted. It is a needless complication and will be used by people as an example of how not to deal with tax avoidance. The tax avoidance that HMRC are concerned about will simply not happen in this area. The cost of establishing a settlement would far outweigh the maximum benefit of £80 per year from the perceived potential avoidance. This draft provision is an example of an obsessive approach to countering avoidance that is obstructing the introduction of sensible and practical legislation for trusts.
21. **Paragraph 6 – 685A Settlor-interested settlements.** This legislation covers what is already current practice. We should be grateful for confirmation that paragraph 1(d) applies in a case where there is a non-domiciled settlor of a settlor-interested trust, and the trustees receive non-UK income which is not remitted to the UK and from which

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they make a distribution. Such income would be covered by section 619 and we assume that the new section 685A will take it out of charge altogether for the recipients.

Chargeable gains

22. **Paragraph 3 – 69B Form of election (by trustees to be treated as non-resident.)** Current legislation allows UK professional trustees to act in relation to settlements made by foreign nationals. It is of benefit to the economy that such work can be done in the UK. The purpose of the election is to make it simpler for UK trustees to act. It is therefore a trade facilitation measure (although it would be difficult to determine its purpose from the explanatory notes).

Unfortunately the proposed provisions appear to be unduly bureaucratic and the form of the election requires information that is not necessary. We agree that information relating to the trustees and the settlors is needed. However, the property comprised in the settlement is not relevant nor is the identity of the beneficiaries. To make matters worse section 69B (2)(d) adds an obligation to produce “such other declarations as the Commissioners may require.” That appears to give HMRC power to obtain whatever other information seems desirable at the time.

Often information relating to foreign settlements is sensitive and private. If such information is required by the tax authority (even though it has no bearing on the UK tax liability) it would make it unlikely that UK trustees would be used. Indeed in these circumstances we understand that some trust advisers would recommend that the settlor should not use UK trustees. It would be especially unfortunate if this trade facilitation measure turns out to have the opposite effect. Accordingly we think that section 69B (2)(a) should be amended to exclude references to the property comprised in the settlement and the identity of the beneficiaries. Also we recommend that paragraph 2(d) should be deleted.

23. **Paragraph 4 – amendments to section 77 TCGA 1992.** We are not sure what you are trying to achieve here. Now that chargeable gains of trusts are taxed at 40% we question whether it is necessary to change this provision. Also the purpose of new section 77 (2A)(b) is not clear and we ask whether it adds anything.
24. **Paragraph 5 – holdover relief and section 169F TCGA.** The policy reason why holdover relief should be denied to a much wider range of trusts is not clear - unless of course it is simply to raise more revenue. There should be no policy reason to deny holdover relief to a settlement for minor children. It creates a further anomaly that an individual would be able to give business property with hold-over to children who are over 18 and indeed to children under 18 who become absolutely entitled to it on their 18th birthday. It is not a sensible public policy to encourage outright gifts of significant funds and important assets to children at age 18. It is a better policy to protect young people using settlements until they are more mature.
25. **Paragraph 8 – Sub-funds.** We note that a sub-fund election is going to be an occasion for charge. It appears therefore that there will be no such elections where a

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significant CGT liability will arise as a result. Accordingly there will be very limited scope for the new provisions and they will not be of much use to trustees. During consultations it was assumed that the measures related to sub-funds were for administrative convenience and were not expected to be an occasion for charge. Explanatory note 100 does not explain the rationale but merely paraphrases paragraph 19 of Schedule 4ZA. However, we think that the provision will result in a CGT liability on unrealised gains. There appears to be no logical reason why a charge should be imposed here. The property remains within the scope of CGT and the base cost would not otherwise be uplifted.

26. Condition 4 for a sub-funds election (included in paragraph 8 of Schedule 4ZA) seems unduly restrictive. Often settlements include provisions to ensure maximum flexibility. It would not be unusual for a person to be a beneficiary under the main settlement as well as under a sub-fund where one has been established.
27. The purpose of paragraph 21 of Schedule 4ZA is not clear. Cash is not a chargeable asset for CGT purposes. Again the explanatory note does not explain the point or say why the new provision is required or what it is meant to achieve.

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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.
4. 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.

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ANNEX B

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.