Tax Representation

TAX FACULTY

TAXREP 11/07

BARE TRUSTS

Text of a letter dated 14 February 2007 and discussion paper and a supplementary letter dated 16 February 2007 sent to HMRC by the Tax Faculty of the Institute of Chartered Accountants in England and Wales

Contents

	Section
Text of letter dated 14 February 2007 and discussion paper	A
Text of supplementary letter dated 16 February 2007	B

Appendix 1 - Who we are

Appendix 2 - The Tax Faculty's ten tenets for a better tax system

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A Text of letter dated 14 February 2007 to HMRC and discussion paper

… We are very grateful to you for allowing us and others the opportunity to give you our views on this very important matter before you go public with a possible change of approach. We commend you on this initiative.

I attach a more detailed paper which we have prepared and summarise our main points as follows:

1 We do not think it could possibly be in accordance with the current state of the law to take the view that where section 31 of the Trustee Act 1925 does not apply, a bare trust for a minor constitutes settled property for IHT.

2 We also take the view that even when section 31 does apply such an arrangement is not within the section 43 definition of settled property for IHT.

3 Where you have legal advice, which I suspect you will on point 2, which conflicts with other advice or opinions then you as policy advisers have to decide what approach you should recommend. In such a case, we do not think that there could be any advantage in seeking to change what has long been the general understanding of the position so that there is a new category of settled property which did not exist previously.

4 If, as we strongly advise against, you thought it appropriate to take such a view, then this would introduce a very unhelpful discontinuity between the treatment of bare trusts for income tax and CGT where the income and gains are recognised as being that of the minor, and that for IHT where they are not. While we accept there has been no intention to seek a complete consistency of definitions across the three taxes, we do not see any advantage in moving further away from it.

5 Such an interpretation is likely to create very real problems in a number of areas. One of these is that of the Child Trust Fund where our understanding would be that all contributions to such funds, including those from the Government, would be within the relevant property regime.

6 We think that there is a need to clarify the treatment now of transitional serial interests and immediate post death interests held by minors since as we understand your interpretation no such interest can now be created.

When you are ready to discuss these matters further we would be very happy to do so as we believe that it is important that such potentially wide-ranging changes are considered very carefully before you come to a final view.

ANNEX

DISCUSSION PAPER ON BARE TRUSTS

By the Tax Faculty of the Institute of Chartered Accountants in England and Wales

Contents

	Paragraph
Introduction	1-3
Discussion of HMRC's view	4-9
Specific points	
S.31 specifically disapplied	10
Powers of accumulation	11-14
Positive duties of trustees	15
Consider a third situation	16-19
Practical issues	
Legal capacity	20-22
Bank accounts for minors	23-26
Child Trust Funds	27-29
Persons of limited capacity	31-33
Conclusion	34-36

Introduction

1. HMRC have recently proposed a change in their approach to bare trusts for minors. This may mean a change in the current treatment of these structures for inheritance tax (IHT) purposes albeit it is not thought that the new approach suggested by HMRC is sustainable under the law as it stands. This paper considers the issues and highlights some of the practical difficulties that may occur if this is the case.

2. A bare trust arises where property is vested in one person (the legal owner) to hold on trust for the benefit of another person (the beneficial owner) absolutely.

3. Where the beneficiary is a minor and property is directed to be held on trust for them absolutely this will, in the light of recent HMRC correspondence with ICAEW, cause IHT issues to arise following FA 2006.

Discussion of HMRC's view

4. HMRC's view, recently circulated to ICAEW, is that, where s.31(2) Trustee Act applies:

- a trust of this type cannot be a bare trust, on the basis that the trustees will have active duties to perform; and
- it is arguable that it would be a "trust to accumulate the whole or part of any income" within s.43(2) IHTA

In addition, HMRC's advice is that it would not make any difference in principle if the statutory power were excluded, since the incapacity of the minor would mean the trustees would have to accumulate surplus income de facto, or as part of the due administration of the trust.

5. This does not seem to reflect the current law. There is Court of Appeal authority in the case of Stanley v CIR, CA 1944, 2 TC 12 which shows clearly that in the absence of section 31, as a matter of general law the income of a bare trust for a minor belonged absolutely to the minor. In his comments on the earlier case of Gascoigne, KB 1926, 13 TC 573 Lord Green said of an absolute vested interest in certain property in Ireland, subject to a direction to accumulate the rents during infancy:

> "The income of the property was hers from beginning to end and the direction to accumulate was mere administrative machinery which did not affect her title in any way".

6. Later in the same speech he refers again to the Gascoigne case and says of the beneficiary there:

> "She could, of course, give no receipt for the income during her infancy, but if she had died an infant any income which had previously accrued and had not been spent on maintenance will have passed to her legal parental representatives as part of her estate".

7. However, HMRC's new approach is that even where s.31 is disapplied, there is a 'de facto' power to accumulate and the fact that the trustees have positive duties to perform, may mean such a trust falls within the s.43(2) IHTA definition, causing it to be a relevant property trust.

8. While we can see that a real power to accumulate will bring property within the wording of section 43(2)(b) we have always understood that in a bare trust the section 31(2) TA 1925 powers are not of such a kind. In the section 31 case, the trustees have power to retain unexpended income as part of the beneficiary's fund. This is an administrative power that results from the inability of the beneficiary as a minor to give a legally valid receipt. In contrast, the normal interpretation of the accumulation in s.43(2)(b) is that the trustees can in effect change the destination of the funds accumulated so that they pass to a beneficiary other than the minor. Section 31 does not allow this to happen as the retained income and anything arising from it is held for the minor absolutely.

9. Our interpretation seems consistent with the Inland Revenue statement of 12 February 1976. This accepts that a power to accumulate does not negate an interest in possession where accumulations are held solely for the person having the interest or his representatives. The situation in a bare trust is precisely that and so it should be subject to the same interpretation.

Specific Points

S.31 is specifically disapplied

10. Where s.31 is disapplied and there is no specific power to accumulate, the beneficiary's rights under the bare trust are not subject to any discretion of the trustees – the beneficiary is absolutely entitled to the income arising at all times, as it arises, subject only to his or her inability to give a valid receipt. The accumulations of income must be held for the benefit of the beneficiary or for the benefit of his or her estate, i.e. the precise situation distinguished in the Inland Revenue Press Notice

dated 12 February 1976 on interests in possession. Where this situation obtains, the trustees have no *power* (within the precise trust context) to withhold income and thus no discretion. This would mean that the trust interest would not fall within s.43(2) IHTA.

Powers of accumulation

11. Powers of accumulation are specific trust powers. The term has been defined by several cases over the centuries and has a precise meaning. It is not thought possible to have a 'de facto power to accumulate' as posited by HMRC. There has never previously been any suggestion that failure to give a valid receipt is tantamount to giving the trustees a power to accumulate and it would appear to be stretching purposive construction beyond the point of comfort or safety to suggest that this is in fact the case.

12. In particular, the argument that a 'de facto power of accumulation' might exist has potentially wider ramifications. For example, where a beneficiary has a qualifying IIP:

    (a) Are HMRC saying that if the trustees purchased an insurance bond with the trust capital, they were de facto accumulating income that might have arisen to them had they held the capital outright?

    (b) Would the position be the same where a roll-up fund without distributor status is acquired?

    (c) At what stage would they judge that a de facto power for accumulation was being exercised?

13. Trustees have to keep an even balance between the interests of capital and income beneficiaries. If HMRC are correct:

    (a) At what stage would the trustees be treated as de facto accumulating income?

    (b) What criteria would be applied?

    (c) Would a chargeable lifetime transfer (CLT) arise if HMRC felt that the trustees had 'overstepped the mark'?

    (d) How would the charge to tax be calculated?

14. The effect of this extension to 'de facto powers to accumulate', if it is correct, is that all bare trusts for minors are either A&M or relevant property trusts, according to when they were set up.

Positive duties of trustees

15. HMRC have said that the fact that the trustees have positive duties to perform means that a simple trust for a minor cannot be a true bare trust. However, the trustees will have active duties to perform in the case of virtually every bare trust, whether for an adult or a minor, so it remains unclear how this affects the position. Taken to its logical conclusion that argument would suggest that all bare trusts would be caught.

This must be wrong, because property is not held in succession or subject to a contingency.

Consider a third situation

16. The bare trust is set up so that s.31 TA is disapplied and the trustees have a positive duty to distribute income, as it arises, to an account for the minor – how the account is set up and organised is a matter between the parents, the minor, and the bank concerned and is not part of the bare trust arrangement in any way.

17. The bank account is set up in the normal course of the bank's business. It is not in any way part of the IHT structure under consideration and cannot possibly be settled property within s.43(2) IHTA, as it satisfies none of the criteria.

18. In such circumstances a bare trust set up in this way cannot possibly fall within even the extension to the accepted definitions recently put forward by HMRC. This should be confirmed by HMRC.

19. If HMRC retains any concerns because the trustees in the example put forward above have a positive duty to distribute the income, will HMRC agree that if the trustees are positively relieved from any obligations to do anything at all, whatsoever, then they cannot be said to undertake positive duties?

Practical Issues

Legal capacity

20. The age of legal capacity in England and Wales is in general 18. In Scotland the age is 16. In some countries, including England, if you marry or enter into a registered civil partnership before age 18 then you will have legal capacity despite being under the normal age when this would otherwise apply.

21. This means that there could well be differences in treatment between minors domiciled in Scotland and England, and minors who are married and unmarried. From a policy point of view this is completely unjustifiable.

22. The impact of HMRC's suggested interpretation of the legislation would be that such gifts by family members to 16 or 17 year old English or Welsh children would be chargeable lifetime transfers, where exemptions and nil rate bands has been used elsewhere, whereas the same gift in the same circumstances to say the 16 year old Scottish nephew or the 17 year old married niece would be a PET. This appears to be an inequitable result and might even potentially to be open to challenge under the Human Rights Convention.

Bank accounts for minors

23. Bank accounts for very young children are usually set up in the form "[parent's name], re: [child's name]". Practice varies, but such an account would not usually be placed into the child's sole name until they reached an age (say 7-8) where they could actually write and sign their own name; however, if the parents do not press for this change to be made, the account may remain in the [parent's name], re: [child's name] format until the child is 11 or 12 years old.

24. Many such accounts will be used to hold the child's pocket money and small gifts and will be of very low monetary value. However there will be cases where relatives make outright gifts of money to the child, which are plaid onto such accounts, whether for birthdays, Christmas, to pay for school trips or to purchase (say) a car on reaching 17. These could be considerably more valuable, and may be in excess of the donor's annual exemptions or small gifts allowance.

25. Potentially, a number of completely innocent transactions post 21 March 2006 may be caught and become CLTs. There will have been no intention of tax avoidance, nor in many cases, any realisation that setting up bank accounts for children in this way might have unforeseen tax consequences. It is doubtful that any large amount of IHT will be generated - nevertheless, taxpayers will be put to extra trouble and expense if bare trusts are, and in fact always have been, a type of accumulation and maintenance trusts. Banks may well have to review their procedures.

26. Further questions will need to be answered:

(a) Does the tax treatment depend on whether the money is in the child's name or the parent's name on behalf of the child?

(b) If a liability to IHT exists, will the HMRC charge attach to the funds in the account?

(c) If this is the case, what procedures should the banks adopt to regulate the position?

Child trust funds

27. In the 2003 Budget, the Chancellor announced the Child Trust Fund (CTF), which began on 6 April 2005. This is a tax regime for children, with contributions to be held on bare trusts until the child reaches 18, at which point the accumulated capital in the trust will belong to the child absolutely.

28. Inter alia, the regulations provide that instructions to the account provider relating to the management of the fund may only be given by the person having the authority to manage it. Where the child is aged under 16 the person with this authority is the "responsible person" (a person who has parental responsibility in relation to the child and is neither a local authority nor a person under 16), and between the ages of 16 and 18 authority rests with the child.

29. Every child born on or after 1 September 2002 receives from the Government an initial endowment of £250 (£500 for the poorest children). A further payment is made when the child reaches the age of seven. Family and friends are able to contribute up to £1,200 per year between them to the fund. All income and capital growth are tax-exempt.

30. No mention is made of any IHT implications, either in HMRC manuals or other professional publications. It is assumed that this is the case because the consequences of the CTF being a bare trust arrangement were expected to flow naturally from it and there has therefore not been any need to comment further. However, if the family and friends do contribute in this way, and have used their

annual exemptions and nil rate bands, it appears that their contributions will, under HMRC's interpretation, be CLTs.

Persons of limited capacity

31. It is not only minors who may not have legal capacity and who are unable to give a valid receipt and who may therefore be affected by this change in interpretation by HMRC.

32. This might particularly apply where a person lacks capacity but does not fit within the criteria for a disabled person's interest (DPI) to apply – for instance adult children or other relatives may hold property on bare trust for an elderly person. In these cases, if HMRC are correct, the interest will be a relevant property trust.

33. This may have a disproportionate and unintended impact in many normal family situations, where a family member has periods of incapacity and intervening periods of capacity as this could mean that there will be an exit charge and a chargeable transfer into trust for each separate cycle of illness and recovery.

Conclusion

34. It is by no means certain that HMRC are correct – particularly where s.31 is excluded and there are no 's.31 type powers' available to the trustees. However, if they seek to enforce this view and change the existing practice, then this may have much further-reaching consequences than just the treatment of bare trusts for minors, and further clarification and guidance is urgently needed.

35. In particular, the following practical issues must be addressed:

(a) What is the start date for this proposed treatment? In any event, we consider that it would be appropriate for there to be at least a two year transitional period, from the date of any announcement of the HMRC view. This would enable people time to understand, or to unravel, innocent arrangements which would be caught under this new interpretation. It is also expected that the banks will require time to consider what to do about their internal procedures on setting up bank accounts for minors.

(b) Does any IHT liability that arises attach to the bank account itself?

(c) Will HMRC charges attach to the property held on bare trust?

36. Issues also arise for IPDI trusts and TSIs – there is no suggestion in the wording of Schedule 20, Finance Act 2006, or any announcements by Government or HMRC that these types of trust were only to be available to adults of full capacity, yet that appears to be a necessary corollary of HMRC's stance on bare trusts for minors. HMRC should confirm the position as soon as possible.

B Text of supplementary letter dated 16 February 2007 to HMRC

Further to our emailed letter dated 14 February, and with thanks for your acknowledgement of 15 February, we have a supplementary point in relation to para 24 of our discussion paper.

The £250 a year small gifts exemption in section 20 IHTTA 1984 was presumably intended to cover gifts made to minors for birthdays, Christmas, etc. If HMRC were, contrary to our expectation, to take the view that such gifts are not 'outright gifts' because any gift to a minor would be regarded as a gift into trust for IHT purposes, then this exemption cannot apply and all such gifts are potentially chargeable transfers unless another exemption applies.

If the small gifts exemption is not available, then in many cases the normal expenditure out of income exemption will apply or, if not, the annual exemption. But there will be many grandparents who make such small gifts out of capital (eg, grandma makes the gift; granddad has the main income and grandma has a small income but reasonable capital) and also give away £3,000 per year to use up the annual exemption. If section 20 does not apply, then all gifts to minors, however tiny, must be added up as chargeable transfers throughout life.

While this point in itself reinforces the need to find an interpretation which does not create this problem, or to recommend legislation to restore the position as it had been understood to be, if that proves not to be the case we would recommend that HMRC should treat 'outright' as applying not only to gifts to adults of legal capacity but also to donees whose gift has to be held in a bare trust, and that an amendment to this effect, which is deemed to have applied since 22 March 2006, should be included in this year's Finance Act.

It is also a nonsense that the £250 annual exemption has not been increased since 1976 and the £3,000 annual exemption has not been increased since 1981, and if you agree that trivial gifts are effectively grit in the system that would be best removed then you might like to consider making appropriate recommendations to Ministers that these thresholds be raised to, say, £1,000 and £10,000 respectively.

PCB
16.2.07

APPENDIX 1

WHO WE ARE

1. The Institute of Chartered Accountants in England & Wales is a professional body representing some 128,000 members. The Institute operates under a Royal Charter with an obligation to act 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 (which includes taxation).

2. The Tax Faculty is the centre for excellence and an authoritative voice for the Institute on taxation matters. It is responsible for tax representations on behalf of the Institute as a whole and it also provides services to more than 11,000 Faculty members who pay an additional subscription.

3. Further information is available on the ICAEW website, www.icaew.co.uk, or visit the Tax Faculty website at www.icaew.com/taxfac.

APPENDIX 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/index.cfm?route=128518***.