THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

Tax Representation

TAXREP 68/05

TRUSTS

TAX LAW REWRITE: BILL 4

Memorandum submitted in December 2005 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an invitation to comment issued in October 2005 by HMRC Tax Law Rewrite Team

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INTRODUCTION

1. We welcome the opportunity to comment on Paper CC/SC(05)36 (Bill 4: Trusts) published on 17 October 2005 by HMRC Tax Law Rewrite Team at http://www.hmrc.gov.uk/rewrite/exposure/menu.htm. This follows up our informal submission made on 19 December.

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 are summarised in Annex B.

KEY POINT SUMMARY

3. Whilst the rewrite is of the high quality to which we have become accustomed and the line for enacting case law and practice is drawn generally in the right place, we have some concerns:

- we do not agree with the intended abolition of the tax pool;
- the tax pool should include the 20% tax credit against tax on gains on single premium life insurance bonds held within a discretionary trust;
- HMRC's practice of not also charging the beneficiaries to tax on discretionary payments to someone other than the settlor of settlor-interested trusts should be provided for in the law;
- the proposed trust expenses legislation:
    - adopts case law the precise extent of which does not have universal acceptance and phrasing which is not supported by the source legislation;
    - will preclude the ability of the courts to reconsider the original legislation;
    - may be more restrictive than at present; and
    - sets out different approaches between accumulating/ discretionary settlements and those with fixed interests, which for mixed trusts will exacerbate complexity; and
- the rewrite covers provisions which are currently undergoing comprehensive policy review.

GENERAL COMMENTS

4. We note that the draft clauses contain the bulk of the remaining specific rules about trusts which will be included in Bill 4. We also note that the approach to the income tax material in sections 25-29 FA 2005, concerning trusts with vulnerable beneficiary, is yet to be decided and that the consequential amendments are not complete.

5. We support the endeavour to make explicit in the draft clauses in accordance with well-accepted practice certain of the more important rules about how trustees are taxed, in particular the mechanics of the way trust management expenses are taken into account and whilst we consider that in general, the Tax Law Rewrite Team have drawn the line in about the right place between going far enough or not far enough on making explicit points which are well accepted in practice, there are certain aspects which we would welcome clarification and codification in the law.

6. The first is the exclusion from the trustees' tax pool of the 20% tax credit against tax on gains on single premium life insurance bonds held within a discretionary trust. Given that the scheme of the existing legislation is that the income tax that the trustees pay goes into the tax pool, we consider that clause 22 should include income tax paid under what is now section 467(7)(b) ITTOIA 2005.

7. The second is the omission to enact HMRC's practice of not also charging the beneficiaries to tax on discretionary payments to someone other than the settlor of trust income taxed as that of the settlor. We consider that clause 17 should make it clear that a discretionary payment of income out of a settlor-interested trust is not treated as the income of the beneficiary and therefore clauses 18 and 19 do not apply in such a case.

8. We note also that the Tax Law Rewrite Team is in close touch with HMRC Trusts colleagues working on the discussion paper about Trust Management Expenses, the drafting seeking to stay in line with the emerging content of that paper so far as the mechanics are concerned, that there is liaison with HMRC Trusts colleagues in relation to the wider work on Modernising the tax system for trusts, and that the draft clauses will be updated at a later stage to reflect any changes made in FA 2006.

9. The Modernisation proposals envisage the ending of the s 687 ICTA 1988 tax pool within a relatively short time and clause 17 onwards may require amendment if these proposals are brought into effect. We do not agree with the proposition that the tax pool should be abolished if income streaming is to be introduced. As noted in our TAXREP 27/05 submitted in June 2005 (see http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_82399) to the trust modernisation team, at present, 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 enables 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. In addition, we see no reason to set a time limit on the life of the tax pool and we think it should be available as long as it is possible to distribute the income as income.

10. We also consider that the Tax Law Rewrite Team has exceeded its terms of reference regarding making policy changes in rewriting the legislation covering trust expenses. As noted in our comments under clause 12 (HMRC's Q4), HMRC has followed *Carver v Duncan* [1985] STC 356, the precise extent of which does not have universal acceptance, and adopting the wording from the judgement could preclude any future reconsideration by the courts of the original legislation. On the definition of trust expenses we are concerned about the enactment of a definition that may be more restrictive than at present, the difference in approaches between accumulating/ discretionary settlements and those with fixed interests – complexity will be exacerbated in the case of mixed trusts, and the rewriting of provisions which are currently undergoing comprehensive policy review.

11. The attempt to rewrite law which is subject to possible early change will represent a waste of Tax Law Rewrite Team time to some extent if the law is in fact so changed, whether before or after the Bill 4 rewrite is completed and, if it is changed following completion of the rewrite, may invite criticism such as followed the Schedule 4 (approved ESOP schemes) post-rewrite amendment to ITEPA 2003. It is certainly a high-risk strategy for the rewrite process and it is unfortunate that the rewrite timing coincides with the consultation on change.

ANSWERS TO QUESTIONS

12. **Q1** We have no objection to the inclusion of the additional material about the meaning of discretion in clause 7(3) (Meaning of "accumulated or discretionary income") which some users may find helpful, but we have to say that the wording in s 686(2)(a) was more elegant**.** Clause 7(3)(a) correctly indicates that the trustees *may* have power to accumulate the income; but this does impair the contrast which clause 7(1) seeks to make between accumulated or discretionary income, with clause 7(2) defining "accumulated" income as income that *must* be accumulated. As the definition of "accumulated" can be construed as being circular – income is accumulated if it must be accumulated – it may be preferable to split clause 7 into two separate clauses, respectively defining accumulated and discretionary income with the latter incorporating the s 686(2)(a) ICTA proviso "whether or not the trustees have power to accumulate it".

13. However the additional material is not helpful to the extent that it raises a doubt over the position where trustees are required either as a matter of general trust law or in accordance with the specific terms of the trust deed to consider whether expenses are allowable against income. We consider that clarification is needed to ensure that clause 7(3) does not apply inadvertently to make income discretionary where trustees are required to consider whether expenses are deductible against income which arguably gives them the ability to decide how much of the income is to be distributed to any person.

14. **Q2** Whether clauses 8(3)(a) or (b) can be omitted depends on whether share buy-backs are income. Clause 8(3)(a) makes it clear that what might otherwise be a double charge to tax is prevented. Without clause 8(3)(a), a buy-back distribution might still be held to be income for the purposes of clause 6 as well as clause 8. We conclude that these clauses should be retained.

15. **Q3** "Expenses" is a wider term than "management expenses" and, whilst the latter will be familiar to users, it does appear preferable to refer in the rewrite to "expenses" in a situation where not all trustees' expenses are allowable and those which may be taken into account are primarily determinable by trust law.

16. **Q4** In principle it is helpful to set out the basic rules about what expenses are allowable. However, we are concerned about the way in which the present legislation in s 686(2AA) has been reworded.

17. By way of explanation, the wording of the existing legislation allows a deduction for trustees' expenses "...which are properly chargeable to income or would be so chargeable but for any express provisions of the trust...". This wording has been more or less consistent since trust rate was first introduced in s 16 Finance Act 1973. Lord Templeman's judgement in *Carver v Duncan* [1985] STC 356 interpreted this as meaning "...requires the express provisions of all trust deeds to be ignored for the purpose of determining which kinds of expenses are deductible". The significance of this is that the legislation says that trustees may deduct expenses properly chargeable to income even if the trust deed states that such expenses are not to be charged to income. What the legislation does not say specifically, but which is how Lord Templeman seems to interpret it, is that any provision in the trust that allows capital expenses to be met out of income should be ignored. HMRC's re-wording here is also different from the treatment of such expenses in fixed interest trusts (see below, Q8. Chapter 7).

18. We question whether a phrase from a judgement ("ignoring any express provision of the trust") should be incorporated into statute as in clause 10(5), when that phrase is not supported by the wording in the statute that it was interpreting ("which would be chargeable to income but for any express provisions of the trust").

19. This overlaps with the proposals/consultations launched by HMRC, which we responded to in August 2005 in TAXREP 36/05 (see http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_84996). Whilst it is not appropriate here to go over the ground contained in that submission, we remain concerned about HMRC's intention to restrict allowability of expenses for accumulating or discretionary trusts and to perpetuate any distinction between accumulating or discretionary trusts and fixed interest trusts. While it may be thought generally to be a good thing to have practice or case law incorporated into statute as part of rewriting the law, where there is uncertainty in the original law or disagreement as to how it should be applied it does restrict the flexibility for judges to interpret (or reinterpret) the position should there be a future challenge on the particular point.

20. **Q5** As explained in Change {jc 522} in Annex 1, and in accordance with accepted practice, we agree the proposal to make explicit the rule that trustees' expenses are grossed up (at the dividend ordinary rate, the savings rate or the basic rate as appropriate) when being set against income charged at the special trust rates.

21. **Q6** In order to make accepted practice explicit, we agree the proposal to restrict the application of Chapter 6 (Discretionary payments) to U.K. resident trustees, provided that ESC B18: "Payments out of discretionary trusts" continues to operate where non-resident trustees pay the appropriate tax and pass the credit through to beneficiaries.

22. **Q7** We agree the proposal, in drafting clause 19 (Statement of tax deducted), to afford the person who is treated as having paid income tax an entitlement to ask for a statement.

23. **Q8** We support in principle the proposal to legislate the established practices as to how trustees' expenses affect the income of a beneficiary. There are however some significant matters that arise which are dealt with in our comments below under clauses 23 and 24.

24. **Q9** We agree in principle that it is helpful to set out the basic rules about what expenses can be used to reduce beneficiaries' income in clause 24 (Restrictions on use of trustees' expenses to reduce the beneficiary's income) but there are some significant matters that arise that we cover in our comments below on clause 24.

SPECIFIC COMMENTS ON DRAFT LEGISLATION

cl 5 Scottish trusts

25. As a policy matter, in clause 5(1)(b) there seems no reason to restrict the application of this deeming provision to a case where the trustees are UK resident. If a trust has effect under the law of Scotland, and the beneficiary has what would be regarded as an interest in possession, then that should be the case whether the trust is resident in the UK or not.

cl 7 Meaning of "accumulated or discretionary"

26. S 686(2)(c)(ii) ICTA 1988 excludes from trust rate tax the income of a personal pension scheme. We cannot see this exclusion in the rewrite.

cl 9 Sums paid by personal representatives to trustees

27. This clause appears to be unnecessary, even though its provisions do appear in the present legislation. If it were entirely omitted, it seems the income from an estate would remain liable to trust rate, in the hands of the trustees of an accumulating or discretionary trust, by virtue of s 649 ITTOIA 2005 and the following sections of Chapter 6 of Part 5 of that Act.

cl 11 How allowable expenses are to be set against trust rate income

28. This clause allocates expenses first to dividend income, then to savings income and lastly to basic rate income. This contrasts with the provisions in clause 16 under which the £500 "basic rate band" of trust income is allocated first to basic rate income, then to savings income and lastly to dividend income. It would be simpler for trustees to understand and apply if all allocations were in the same order and we suggest that the ordering for expenses in clause 11 should follow the ordering in clause 16.

29. There is no Step in sub-clause (1) making provision for the circumstance that trustees' allowable expenses (by whatever definition) exceed the income. Is that deficit of income to be carried forward, to reduce the subsequent year's income? It should be – this is present practice.

cl 14 The "applicable period" in relation to shares

30. (8) Should the definition of "readily convertible assets" be made subject to clause 14(7), as s 686C(4) is subject to s 686C(5) in the source legislation?

cl 17 Discretionary payments by trustees

31. Present HMRC practice is that income that is treated for income tax purposes as income of the settlor is not taxed again if distributed by the trustees in the exercise of their discretion. Where a settlor sets up a trust for his minor children, and the trustees make discretionary payments of income, then those are treated as income of the settlor under s 660B ICTA 1988 now s 629 ITTOIA 2005. For a settlor-interested trust not involving minor beneficiaries there was a Revenue practice in that payments by the trustees in the exercise of their discretion were regarded as perfecting the settlor's gift. Accordingly, they were not charged again to income tax as the settlor has already been charged to tax on the income. Indeed, we believe it that was the requirement for the income to be treated as that of the settlor for all purposes of the Tax Acts that led to this practice in order not to tax the income again as the income of someone else. We therefore consider that clause 17 should include a provision making it clear that a discretionary payment out of a settlor-interested trust is not treated as the income of a beneficiary, and therefore that clauses 18 and 19 do not apply in such a case.

cl 18 Grossing up of discretionary payment and payment of income tax

32. (2) We consider that it should be specified that the trust rate is that rate for the year in which the payment is made, as in the s 687(2) ICTA source legislation, or is it intended to cover this in the meaning of "grossing up" to be given in an Interpretation Part of the Bill (Explanatory Notes paragraph 87 refers)?

cl 21 Calculation of trustees' tax pool

33. This incorporates a Change, described in Explanatory Notes, Annex 1, {jc523}. Our members' experience of how non-UK resident trustees are affected is not completely in line with what is set out in HMRC's paper. Some non-UK resident trustees are prepared to comply with s 686 onwards, as if they were UK resident, in order that their beneficiaries can get the full benefit of the tax suffered at source by the trust. HMRC's proposals would disadvantage beneficiaries in such a case.

34. Additionally, this is another area (see Trust Management Expenses, Q4. Clause 10, above) where it is unfortunate that a re-write is being used to introduce a change to the legislation.

35. We note from Explanatory Notes paragraph 97 that consideration is being given to whether to legislate ESC A68 which provides for a reduction in the tax pool when an amount is paid by HMRC to the trustees of an employment-related trust where a discretionary payment is taxed as employment income. We consider that there can be no justification for not legislating along the lines of ESC A68. Without that concession, there would be a double charge to tax on such payments, both as a distribution from a discretionary trust and as an employment-related payment.

cl 22 Types of income tax for the purposes of section 21

36. In rewriting s 687 ICTA (Payments under discretionary trusts) we note that s 687(3)(d) and s 687(3)(g)-(k) are repealed as spent provisions, and that reference to s 568(5) of ITTOIA 2005 is now correctly included. It will clearly be necessary to keep this section (which is effectively a list of provisions) under review in future if it is to be kept up-to-date, amending it as necessary for repeals and any new legislation.

37. Although not listed in the origins of clause 22(1), we assume that s 687(3A) ICTA is taken into account in the drafting of clause 22, as restricting the application of paragraphs (a1) to (bc) in s 687(3) ICTA, through the words "and on which tax is charged at the dividend trust rate by virtue of section 6" at the end of *Type 2*.

cl 23 Application of Chapter

38. (1)(b) It seems the intention is to apply this to trusts where there is a fixed interest, that is the trust is not accumulating or discretionary. However, the wording would seem to apply also to settlor-interested trusts. We presume that this was not intended, because at present settlor-interested trusts have no deduction for expenses.

cl 24 Restrictions on use of trustees' expenses to reduce the beneficiary's income

39. We are not sure that there is anything that could be called general agreement here. Accordingly we cannot support a proposal that enshrines into legislation for the first time a difference in the treatment of expenses between fixed interest trusts and others when that distinction is not clear in the law at present. Such differences will be confusing for trustees, and additional complexity will be added in the case of mixed trusts, which is contrary to our Ten Tenets for a Better Tax System (Annex B).

40. The present law is that any unrelieved income expenses are carried forward to reduce the income of the beneficiary in future years and clause 24 needs to be amended to achieve that result. For example, in year 1 trustees have expenses which they can charge against income of 300 and income of 100. In year 2 they have income of 300. The correct analysis is that the beneficiary has no net income in year one and only 100 of income in year two. The tax treatment should still be the same.

DETAILED COMMENTS ON DRAFTING

cl 8 Dividend trust rate for trustees' share buy-back receipts

41. (1)(a) This refers to a "qualifying distribution" but it does not seem to be defined in the draft legislation. In the source legislation, the definition is what is now clause 8(1)(b). Consideration might be given to omitting the word "qualifying".

42. (3)(a) Perhaps there should be inserted the word "otherwise" between "is" and "accumulated".

cl 10 Trustees' expenses to be set against income charged at special rates

43. (5)(b) We suggest replacing "...dealing with how the expenses are to be charged" with "...that prevents expenses being charged to income". This is closer to s.686(2AA)(b).

a. We suggest inserting "under this section" between "allowable" and "if", otherwise it could conflict with Chapter 7. Also, we would delete the words "have fallen, or may" as they seem to add nothing to the meaning.

44. (6) In Explanatory Notes paragraph 46, in the first line, delete “an”.

cl 12 Non-UK resident trustees

45. We suggest that it would be a little clearer if sub-clause (5) came in front of sub-clause (1). It is not until one reaches (5) that it is stated to what this clause applies.

Chapter 4 Share incentive plans

46. Overview. In Explanatory Notes paragraph 58, in the third line, the words “provides means that charge” appear to require some correction.

cl 15 Interpretation of Chapter

47. (3) Should the reference to “provision of forfeiture” be instead to “provision for forfeiture” as in the source s 686B(7) ICTA? .

cl 19 Statement of tax deducted

48. In Change {jc 524}, in the third paragraph, the reference should be to “section 629 of ITTOIA” and not to “section 629 of ICTA”.

cl 25 Non-UK resident beneficiaries

49. The heading states “Non-UK resident beneficiaries” but the wording of the clause does not. As clause headings are not part of the substantive legislation, should it not be stated in the clause that it applies only to non-UK resident beneficiaries?

cl 26 Meaning of “untaxed income”

50. (3)(a) In the final line of clause 26(3)(a), and within the brackets, “resident” should be “residents”.

TJH/PCB
22.12.05

ANNEX A

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 our 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.

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.