Tax Faculty

Tax Representation

TAXREP 10/04

MODERNISING THE TAX SYSTEM OF TRUSTS

Memorandum submitted in February 2004 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to discussion papers issued in December 2003 by the Revenue

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MODERNISING THE TAX SYSTEM OF TRUSTS

GENERAL COMMENTS

1. We welcome the opportunity to comment on the discussion papers published by the Revenue on 11 and 17 December 2003 on the web at http://www.inlandrevenue.gov.uk/consult_new/index.htm. We have attended meetings with the Revenue on this topic and look forward to being involved in any further discussions.

2. With any proposed change in the UK's extremely complicated tax system, the burden is on the government to show why it is necessary. Moreover, any changes must not only improve the present law and its administration but outweigh the undoubted confusion and consequent additional complications which they will cause. Although not perfect, the present system for taxing trusts is stable and relatively well understood by advisers. We do not consider that there is a need for wholesale reform.

3. A number of the proposed changes are only necessitated by the decision to increase the rates of tax from 34% to 40% leading to disproportionately high tax charges on trusts with beneficiaries on low incomes. We are not convinced that the 6% increase is necessary to meet the stated objective of preventing avoidance. If the increase were withdrawn the need for wholesale change and disruption would disappear.

4. There are many parallels to the changes proposed in the consultation paper issued in 1991 by the Revenue to which we responded in October 1991 (technical release no 848). On that occasion the government concluded that the current system was satisfactory overall subject to making specific improvements. In our view, that conclusion still holds good.

5. However, this is not to say that there are not specific areas that could not be improved and the discussion papers contain some useful ideas which might profitably be explored. However, this does not justify wholesale reform of the taxation of trusts.

SPECIFIC COMMENTS

Rate applicable to trusts ('RAT')

6. The reason given for increasing the rate applicable to trusts is to prevent the use of trusts as a means of avoiding income and capital gains tax. Given the costs of creating and administering a trust, we suspect that few are set up solely to save 6% tax. In any event, there are specific anti-avoidance rules which apply to settlor-interested trusts which in many cases cause tax to be chargeable at the settlor's marginal rate.

Ideas in the Revenue papers worthy of further consideration and areas of concern

Election for treatment as transparent

7. The ability of certain trusts, in particular those for disadvantaged groups, to be able to elect to be transparent is a promising idea and is worth considering applying more generally.

We also welcome the proposal (at para 29 of the CGT paper) to treat settlor-interested trusts as transparent for capital gains tax purposes.

Definition of settlement

8. We agree that it would be helpful to have a rationalisation of the definition of settlement. We also agree that there is a need to have a wider definition of settlement for anti-avoidance purposes and that it may be necessary to have a different and wider definition for taxing offshore trusts. However, it should be possible to have only three definitions of settlement: a general definition (we recommend the current capital gains tax definition) and separate definitions for onshore and offshore settlor-interested settlements. In relation to offshore settlements, the existing definition in section 77, Taxation of Chargeable Gains Act 1992 might be used as the starting point.

Bare trusts and settlor-interested trusts

9. We agree with the proposal in para 25 of the Definitions and Tests paper that bare and settlor-interested trusts should be taxed on the beneficiary and settlor respectively as if they owned the asset, but for trusts generally we consider that the current rules should apply.

Residence of trusts

10. We agree with the approach of continuing to treat trustees as a single body of persons (para 56 of Definitions and Tests paper). We suspect that the proposal to treat a trust as being automatically resident in the UK if one such trustee is resident would be detrimental to UK trust professionals. We are therefore of the view that the capital gains rules should be used to determine residence for both capital gains tax and income tax..

Principles behind settlor-interested trusts

11. In paragraph 35 of the Definitions and Tests paper there is a statement that there is a 'general consensus that the principles behind the settlor-interested tests are fair.'. We are not aware of any such consensus. The rules are often capricious in their application deeming a settlor to have realised gains on disposals of assets in which he has only the most tenuous of interests. A true modernisation of the tax treatment of trusts would resolve these anomalies by adopting a more restricted definition of settlor-interested trusts in relation to both offshore and onshore trusts and would also restrict the settlor-interested charges to situations where the trust was settled with a tax-avoidance motive.

Uncertainty

12. There is a large amount of complexity and uncertainty in the proposed tax anti-avoidance provisions. In the absence of draft legislation, it is impossible to judge how the proposed changes improve or worsen the position. Moreover, by their very nature, anti-avoidance provisions are difficult to interpret and it could take many years before their full effect is known.

13. A self-assessment tax system needs to be certain if taxpayers are to be able to comply satisfactorily. The prospect is that these proposals will lead to loss of certainty for

taxpayers. The proposed changes must be demonstrably better before legislation is enacted, and should conform with the Tax Faculty's ten tenets for a better tax system summarised in the Annex (and first proposed in 1999 in our discussion document TAXGUIDE 4/99, see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160).

14. Where there are anti-avoidance provisions, it is difficult to design a system that is easy for taxpayers to comprehend and the tax authorities to administer fairly as everyone will have to consider whether any transaction is caught. The current trusts anti-avoidance provisions are wide-ranging and generally effective.

15. At a time when considerable parts of the UK fiscal legislation in direct tax have been called into question from cases brought before the ECJ, we believe that it is essential to first examine the impact of these proposals in the light of EU, human rights and competition law. In particular we are especially concerned that mistakes in drafting could result in considerable costs arising to taxpayer and Revenue alike litigating the key issue of freedom of establishment before the European Courts. We believe that the regime put forward should be equitable and even handed to all taxpayers whilst being resolute in the defence of national revenue. Whilst we know that the Revenue examine all new proposals in relation to EU rules, we are not convinced that these proposals would survive the rigorous scrutiny of litigation before the ECJ.

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ANNEX

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.