THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW TAX FACULTY REPRESENTATION

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FINANCE (NO 2) BILL 2010: CLAUSE 7: SETTLOR TO RETURN EXCESS REPAYMENT TO TRUSTEES ETC

Text of Report Stage Parliamentary Briefing submitted on 4 November 2010 to MPs by the Tax Faculty of the Institute of Chartered Accountants in England & Wales

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1. BACKGROUND

We appreciate that issues with this clause were raised at Finance Bill Committee Stage and welcome the Minister's comments. However, we are concerned that the issues arising as a result of this clause are so fundamental that changes are required, as we explain further below. The background and operation of this clause are set out clearly in the explanatory notes and accordingly we do not intend to repeat them here.

It is our understanding that the underlying policy objective is ***that the trustees should suffer the income tax but that the tax charged should be calculated as if the income arose to the settlor (that is at the settlor's marginal income tax rate, which may be different to that that the trustees would have paid)***. The current legislation provides a mechanism to achieve this aim where the liability of the settlor is greater than the tax paid by the trustees as the settlor is entitled to recover the additional tax he has had to pay from the trustees. The objective behind clause 7 is to achieve symmetry where the opposite occurs, namely that the tax liability of the trustees is higher than that of the settlor with respect to the trust income – a situation which is likely to arise much more often given that for accumulation/discretionary trusts the alignment of the trust tax rates with the additional rates of tax may well result in the trustees' liability to tax being higher than the tax due from the settlor (the settlor being liable at his marginal income tax rate). Clause 7 is designed to ensure the settlor must repay any credit he or she receives by reason of the tax paid by the trustees exceeding that to which the settlor is liable.

2. THE PROBLEM AND PROPOSED SOLUTIONS

Whilst we support the principle which has led to clause 7 being introduced, we do not think that clause 7 is the best way to achieve the underlying policy objective (as set out in italics above). Taxing, under different principles, both the trustees and the settlor on the trust income will inevitably lead to issues in achieving this objective and the need for either reimbursement or repayment. This is burdensome on the trustees, the settlor and, given the need in either case to provide a certificate, HMRC.

The new clause 7 is likely to impose a considerable extra and onerous burden on trustees. This is because trustees are under a fiduciary duty to collect in the assets due to the trust fund and would, therefore, be obliged to make enquiries and seek to recover any amount which might be due to them or risk being in breach of their fiduciary duty. The clause appears to be predicated on an assumption that all settlors will now complete either a self-assessment return or a repayment claim. Unless the filing obligations are changed to make this mandatory, this may not always happen.

The burden on trustees is made worse by the fact that the current clause 7 allows the settlor to ask for a certificate showing the tax due to the trustees, but gives the trustees no such rights. A trustee, therefore, has a fiduciary duty as explained above to recover any tax the HMRC certificate says should be paid to them by the settlor but no information and no means of forcing the settlor to either make the necessary submission to HMRC or account for the overpayment. We therefore believe that this clause will place an unfair burden on trustees.

Given these issues we would prefer that this clause were dropped and instead suggest that the Office of Tax Simplification should be asked to look at how to achieve the fundamental objective behind the legislation in a better way and make recommendations for change. We propose that

thought be given to moving to a look through solution, with the settlor being taxed rather than the trustees but having recourse to the trustees for the tax payable. We believe that this would be far simpler and not leave any scope for avoidance, as the tax situation would be the same as if the settlor had retained the assets.

We would be happy to work with the Office of Tax Simplification on this project and if accepted would suggest that as well as the unnecessarily complex income tax provisions, the inheritance tax and capital gains tax issues are also considered as the legislation can operate in ways that are punitive when such trusts often serve very useful purposes. For example, settlor interested trusts can be particularly useful for vulnerable individuals such as those suffering from degenerative illnesses, addiction or conditions where you move in and out of mental capacity. Trusts give considerably greater protection against financial abuse than enduring or lasting powers of attorney and are a more flexible method of managing a patient's financial affairs than under a court of protection deputyship.

If the Government is not minded to do this we would suggest that the three issues below are addressed to clarify how the legislation should operate.

a) The problem with the term "repayment"

The problem over the definition of repayment was discussed in the Finance Bill Committee stages. We welcome the Minister's statement that *"HMRC will be working with professional bodies to ensure a common understanding of the existing rules"*. However, since the issue at stake is the way the tax burden is shared between two different persons we feel that the point is so fundamental that there needs to be a legislative definition to clarify the procedure here. For the avoidance of doubt the definition should only apply for the purposes of s 646, ITTOIA 2005 and would have no impact on any other part of the tax code.

… The word "repayment" has been used in the legislation and no definition is provided, so the normal dictionary definition must apply, meaning that the settlor only has an obligation to account to the trustees where he or she receives an actual repayment. However, providing that the settlor has to account for any tax only when he or she receives an actual "repayment" does not ensure that the position of the settlor is tax neutral (that is he or she neither suffers the tax liability on the trust income nor benefits from excessive tax paid by the trustees). Currently, as the clause only specifies that the settlor need pay to the trustees any repayment, the settlor can benefit from excessive tax paid by the trustees. The trustees will have paid excessive tax where the tax paid by the trustees is greater than the tax the settlor has to pay on the trust income and the settlor will be able to benefit from this where the he or she has a liability with respect to other income as the credit can be set against that liability.

We understand that it might be considered that guidance in this area can resolve the problem by specifying that "repayment" be seen in this context as referring to the settlor paying to the trustees the excess tax credit. We do not see how this can be correct as guidance does not have statutory authority, so we cannot see how it can override the clear wording of the legislation.

To achieve the objective behind clause 7 while also giving settlors and beneficiaries certainty we propose the follow amendments:

Suggested amendments

Clause 7, page 9, line 3

The situation would be simpler if a means could be found under which the tax computation would automatically identify the excess tax credit such that it was not offset against the settlor's individual liability and the excess amount were transferred by the HMRC system such that it showed as a credit on the trustees' self-assessment statement of account. Equally, where the figures are such that the trustees have paid insufficient tax, rather than the settlor having to make good the

difference and reclaim this it would be easier if the system showed the liability on the trustee's statement of account. If the computer system could achieve this it would represent a significant easing of administrative burdens as the tax would only have to be paid once by the person who it is agreed should bear the burden.

For "obtains a repayment" substitute "receives an excessive tax credit

Clause 7, page 9, line 7
Delete line 7

Clause 7, page 9, line 9
"(6A) In subsection 4 the excessive tax credit and in subsection 5 the excess refer to the same amount. This amount should be computed in accordance with regulations to be laid before the House of Commons which will have effect from 6 April 2010"

The regulations would only have effect with respect to defining the terms excessive tax credit and excess for the purposes of s 646, ITTOIA 2005. We suggest that any such the regulations be modelled on the Inheritance Tax (Double Charges Relief) Regulations 1987 (SI 1987/1130) in that they should contain both instructions as to how to compute the excess and examples. In line with the Ministers comments at the Committee stage HMRC should work with the professional bodies to agree the principles on which the regulations should be based.

b) The trustees should be able to make the request for the certificate

We very much welcome the inclusion within clause 7 of the certification process at sub-clause (4). However, we believe it should be the trustees who can request the certificate. It seems to us to make sense for the person who is owed funds to be the one who can ask for the certificate. Where the settlor seeks reimbursement of tax he or she has suffered, the settlor can ask for the certificate. When the trustees are seeking repayment, it should be they who can request the certificate. In addition knowing the amount at stake will assist trustees in determining the efforts that should be gone to in order to recover the sum.

Suggested amendment

Clause 7, page 9, line 9 substitute "trustees" for "settlor".

As explained in section 2 above, we believe that without this change trustees will be put in an invidious position as they will have no means of knowing whether or not a payment is due to them from the settlor. Indeed, as every trustee will need to consider the issue (given the fiduciary duty to collect in assets due to the trust) we would suggest that rather than have a request procedure it might be simpler to have an automatic requirement for HMRC to provide the necessary certificate to the trustees as this will avoid the administrative burden of the trustees having to ask for the certificate and the need for HMRC to process the mail this will generate.

c) Specific exemption from an inheritance tax charge

We welcome the Minister's comments in the Finance Bill Committee to the effect that this clause would mean that the payment to the trustees by the settlor would not be a transfer of value for inheritance tax purposes. We appreciate that this is the clear intention but we are not sure that this intention is explicit within the legislation (though we accept it could be said to be implicit) we would ask that it be made explicit on the face of the legislation.

Suggested amendment

Clause 7, page 9, line 18 insert:

"(6C) Any payment from the settlor to the trustees under the terms of sub-section (5)is specifically excluded from being a transfer of value for the purposes of inheritance tax or seen as an addition to the trust for any other tax purposes."

Further information

Please do contact the ICAEW if you require any further information:

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APPENDIX 1

WHO WE ARE

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions 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 Institute who pay an additional subscription, and a free weekly newswire.

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.com/index.cfm?route=128518).

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