

PARTIAL REGULATORY IMPACT ASSESSMENT (RIA)

Modernising the tax system for trusts

Purpose and intended effect of the measure

The policy objectives

1. The objectives of modernisation are to simplify the tax regime for all trusts, reduce burdens on smaller trusts, and to ensure that certain trusts set up for the vulnerable are not disadvantaged by the change in the rate applicable to trusts (RAT) from 34 per cent to 40 per cent.

Background and introduction

2. The current tax rules for trusts are complex, and many of the definitions used and key tests applied differ for different taxes. This complexity drives up compliance costs, and can make it hard for lay trustees to self assess accurately. A simplified system could provide scope to take around one third of all the trusts paying tax at the RAT out of the full Self Assessment (SA) system.

The risk(s) being addressed

3. The complexity of the current tax rules means that trustees, particularly unrepresented trustees, very often make mistakes in completing their Self Assessment returns. Simplifying the system and harmonising the definitions used for income tax and capital gains tax makes it less likely that unrepresented trustees will make unintentional errors.

Options

4. A variety of different options for modernising the tax system for trusts were put forward in the discussion papers issued on 17 December 2003.

The ideas Ministers wish to take forward are:

Introducing a basic rate band for all trusts

- This would be set at £500, which would mean around one third of the trusts which are currently liable at the rate applicable to trusts (RAT) would not need to make an annual Self Assessment return. This would in turn reduce their compliance costs.

Clarifying and reducing the number of definitions

- At present there are at least 27 different sorts of trusts for tax purposes, three different approaches to defining “settlement” and nine different tests for “settlor-interested” trusts. Reducing these would make it easier for trustees to understand and thus comply with their obligations.

Trusts for the vulnerable

- It is proposed there would be an election providing for certain vulnerable beneficiaries of trusts to be treated as if they owned the trust assets themselves. This would mean that for tax purposes we would tax the trustees on the basis of the beneficiary’s personal circumstances.

Streaming of income and gains

- Where income and gains arise to trusts and are passed rapidly on to trust beneficiaries, there may be a case for exempting the trustees from the RAT, and instead taxing them at no more than basic rate. However such a system would be complex and further work and consultation will take place before a decision is taken whether or not to proceed.

Trusts Management Expenses

- Trust Management Expenses (TMEs) are expenses incurred by trustees in the administration of their trust duties, and there is widespread confusion about what TMEs actually are and the extent to which they are allowable for tax purposes. In response to comments on the discussion papers, we will work with representative bodies to provide improved guidance in this area.

Other measures

- There are a number of other measures under consideration which would tidy up anomalies and inconsistencies in the tax code for trusts. These include changing the way settlors of settlor-interested trusts are taxed so that they are charged not under Case VI of Schedule D but under the appropriate case for the income, providing a common charging mechanism for income that is capital in trust law but charged to income tax, and amending the capital gains tax regime for deceased estates.

Business sectors affected

5. The main sectors affected will be:

- the legal profession;
- professional trustees;
- corporate trustees.

Issues of equity and fairness

6. The Government recognises the important role trusts play in society. As far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust but, equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits.

7. The Government does not want a system that enables people to use trusts to avoid tax but, equally, as far as possible it does not want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as the laws of intestacy.

8. The Government is not attracted to changing legislation for the sake of change, so would prefer to build on what we have rather than start again from nothing. The Government wants to reduce the compliance burden on small trusts and believes that any new measures should:

- be fair;
- support the competitiveness of the UK economy;
- be clear and easy to operate.

Benefits

9. The benefits of trusts modernisation will be:

- a simpler system, reducing administrative burdens on trustees; especially those responsible for small trusts;
- less tax paid by certain trusts established for vulnerable beneficiaries;
- greater consistency in tests and definitions across the income tax and capital gains tax regimes.

Costs

Policy costs

10. None evident at this stage.

Implementation (compliance) costs

11. Implementation of the changes proposed will undoubtedly result in costs being incurred by those trustees who use automated systems for passing

income out to beneficiaries and for completion of SA returns. There should however be savings for the smallest trusts, many of which will not have to complete a Self Assessment return each year. Until the exact shape of the new system has been decided it will not be possible to accurately determine these costs, but any comments on possible costs / savings to trustees and others affected by the proposed changes are welcome.

Exchequer effect/distributional impacts

12. As for implementation costs, it will not be possible to determine these costs until the exact shape of the new system has been decided. However, the basic rate band for trusts will cost approximately £3m.

13. If income and gains are streamed through a trust to beneficiaries, thus avoiding payment of tax at the RAT by the trustees, then the tax yield from trustees will fall, though there will be no overall income tax impact to the exchequer as the beneficiaries will continue to be liable on that income at their own appropriate marginal rates of tax.

14. The proposal to tax trusts for the vulnerable as if the income or gains arose to the beneficiary will also result in less tax being paid by the trustees.

Small Business impacts

15. This package of measures is likely to impact on small firms of solicitors etc. who are acting trustees. Other than that, the Government considers that the impact of the changes on small business will be minor, but any comments as to how these changes might affect small businesses will be most welcome.

Other costs and benefits (public & private sector)

16. There will be costs associated with any changes for the Inland Revenue. The trust and estate SA return will need to be amended, changes will be needed to the IT systems that support trust work, staff will need to be trained in the new systems, and both internal and external guidance will have to be produced. There will also be costs associated with the changes for other parts of Government dealing with trusts, such as the Official Solicitor's Office /Office of the Public Trustee.

Unintended consequences

17. The new basic rate band for trusts could encourage settlors to establish a number of small trusts rather than one larger one, or alternatively trustees of existing trusts will parcel out the existing trust fund into number of smaller funds. This will require anti-avoidance legislation.

Other impacts

Devolution

18. None at present. The current review of Scottish trust law may have some minor implications for trusts modernisation, but consultation has taken place in both Scotland and Northern Ireland to ensure that changes will work consistently across the UK.

Human Rights

19. It is possible that some Human Rights Act issues could affect some of the ideas put forward for discussion. This will be clarified once the final shape of the tax package becomes clearer.

E-policy

20. Trustees should continue to be able to e-file their returns, as they can at present. No other impact.

Environmental impacts

21. None.

Rural proofing

22. None.

Competition assessment

23. The package will impact in the main on resident personal trusts, and will therefore be at a personal level rather than on business.

Securing compliance

24. One of the intended effects of the modernisation exercise is to make it easier for trustees, especially unrepresented trustees, to comply with their tax obligations. The measures being suggested are aimed at simplifying the tax regime and providing easier ways for small trusts and trusts for the vulnerable to comply, so there should be relatively little danger of non-compliance.

Consultation

25. Discussion papers were made public on 17 December 2003, and comments were invited from all interested parties. In addition, a number of discussion meetings were held in London, Edinburgh and Belfast. As at the deadline for responses of 18 February, 117 people had attended the nine discussion meetings and had the opportunity to comment directly on the proposals and to offer alternatives, and 79 written responses had been received.

26. The intention is to publish draft legislation around the time of PBR 2004, with final legislation being put in place by the 2005 Finance Act. This will offer interested parties a further opportunity to comment on the proposals before the legislation is put in place.

Monitoring and evaluation

27. On the assumption that these proposals are implemented, the Government will want to monitor the number of trusts affected by proposals such as the basic rate band, vulnerable trusts and income streaming.

28. On some of the other proposals, such as harmonising the definitions used for income tax and capital gains tax, the Government anticipates a survey of trustees may be needed to provide evidence of the effect of the changes.

Summary

29. It is clear that there is a good deal of scope to modernise the tax system for trusts, and a good deal of consensus that this is a positive thing to do. Many of the ideas floated in the Inland Revenue discussion papers have been warmly welcomed by respondents, though some ideas clearly require more work and analysis before Ministers decide whether and if so how to take them forward.

30. The announcement of the broad shape of the regime gives a general pointer to some of the changes that will be made. To fully evaluate the impact of the measures, we will have to wait until the exact shape of the modernisation package has been determined but comments on possible administrative costs or savings to trustees or others as a result of implementing any changes are welcome.

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