MODERNISING THE TAX SYSTEM FOR TRUSTS

Discussion paper – Capital Gains Tax issues

1. The Government recognises the important role trusts play in society and has said that 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 the use of trusts where their use would bring significant non-tax benefits. It does not want a system that enables people to use trusts to avoid tax but neither, as far as is possible, does it want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as the laws of intestacy, or where a trust exists to protect the vulnerable, such as a disabled person. Administration and compliance costs should also be kept as low as possible.

2. Within that general framework, this paper examines particular changes that might affect Capital Gains Tax (CGT) for UK-resident trusts. We would welcome views on the ideas discussed below.

Streamed gains

3. We are considering altering the treatment of income that arises to a trust and is passed rapidly on to trust beneficiaries. In such circumstances, the income could be exempted from the Rate Applicable to Trusts (RAT). This proposal is discussed in the Income Tax discussion paper and we would like to discuss the feasibility of introducing a regime for CGT purposes with comparable effects. So where gains accruing to trustees were passed rapidly to beneficiaries, the tax liability would be computed by reference to the circumstances of those beneficiaries. We would like to know if people consider that something on these lines would be an improvement on the current regime for resident trusts. We would also like to hear people's views as to the practical difficulties such a system might create, and how best such a system might operate in practice.

4. At present trustees pay CGT at the RAT on their chargeable gains, subject to allowances and deductions such as taper relief, losses and the annual exempt amount (AEA). The proceeds of disposals may be passed through to beneficiaries, but those beneficiaries are not charged to CGT on these proceeds, and so the tax paid by trustees is the final tax charge.

5. This means that beneficiaries who are liable at lower or basic rate effectively pay more tax than if the gains had arisen to them directly.

Balancing fairness and complexity

6. In outline, such a system would provide for gains that are passed rapidly through to trust beneficiaries, or gains where beneficiaries become absolutely entitled to trust assets as against the trustees, to be effectively taxable on those beneficiaries. It might work by treating the beneficiaries as

owners of the asset in question, or alternatively by treating them as having a chargeable gain of an amount equal to their share of the chargeable gain made by the trustees. The trustees would pay tax at the RAT on such gains, but the gains would be entered on the beneficiaries' personal SA returns, and the latter would in effect pay CGT on their chargeable gain at their own marginal rates of tax with a credit for the tax paid by the trustees.

7. We think such a system would only be workable if the beneficiary actually received the proceeds of the disposal within a certain time scale, probably no later than the end of the tax year in which the gain was realised. However, we appreciate that this might cause difficulties where assets were disposed of near the end of a tax year. We think there may be a case for extending the exemption from the RAT to gains where the proceeds are passed on to beneficiaries at the start of the next tax year.

8. We would envisage treating such gains as being the beneficiary's gains for all CGT purposes. So the beneficiary would be able to set their personal capital losses and their AEA against them. But any trustees' allowable capital losses could not be set off against these gains.

9. Where gains were realised by trustees and the proceeds were not passed quickly through to a beneficiary then the current regime would continue to operate. The trustees would pay tax at the RAT and the proceeds of the gains would be available to pass on to capital beneficiaries free of further tax.

10. This system has various attractions, most particularly the fact that beneficiaries would no longer have to suffer an effective tax charge that may be quite unrelated to their own financial circumstances. However, it also has potential to add an unwelcome degree of complexity to CGT computations and returns.

11. There may also be difficulties where there are a number of beneficiaries who receive payments from the trustees, particularly where the beneficiaries' entitlement results from an exercise of the trustees' discretion to appoint capital. Should relief therefore be restricted to cases where long-standing beneficiaries receive sums or assets representing their actual or contingent share of the capital? There are also various issues around how to establish the amount of chargeable gains taxable on beneficiaries in more complex circumstances, as well as detailed issues such as determining the base cost of the asset and its treatment for CGT purposes when it entered the trust (how to deal with hold-over relief, for example), and taper relief issues such as how long we would deem the asset to have been owned at the time of its disposal, and so on.

12. Given these difficulties, we would like to hear views about the benefits of such an approach, and how well these stack up against the potential problems outlined in the preceding paragraph. We would also like to know if there is another way to broadly achieve the same ends without the complexities and difficulties explained above.

Trusts for the disadvantaged – beneficiary election

13. Raising the RAT to 40%, whilst part of a balanced package designed to reduce the scope for using trusts to avoid tax, has the potential to disadvantage certain trusts established to benefit the vulnerable. The Government wants us to explore ways of mitigating the effect of the rise in the RAT for such trusts.

14. One method of achieving this might be to permit an election, by an appropriate person, for the tax liability of the trust to be based on the position of the principal beneficiary rather than the trustees. This may be a fair approach, if the tax effects would be broadly the same as if that beneficiary owned the assets directly. As the great majority of such beneficiaries will have starting and 20% rate bands available to them, they would pay tax at a rate appropriate to their individual circumstances.

15. We think there would be two main alternative approaches to this; either deeming the beneficiary to be the owner of their share of the trust assets, and taxing them accordingly, or accepting the reality of the trust and providing specific rules, for example to treat the beneficiary as having an interest in possession in the trust property. For the purposes of CGT, we could then copy the mechanism in Section 77 TCGA 1992 to deem the beneficiary to have chargeable gains of an amount equal to the amount of the trustees' chargeable gain.

16. We would welcome views as to which of these would be the preferable approach to take. We would also like to hear people's opinions as to whether there would be alternative models worth exploring for improving the system for deserving trusts.

Trusts for orphaned children

17. Certain trusts established for orphaned children may accumulate income when it is surplus to what is needed for the benefit of the child in any given year. This brings the trustees within the scope of the RAT for Income Tax. In addition, capital gains realised by trustees are taxed at the RAT, subject to various reliefs and a reduced CGT annual exempt amount.

18. For trusts established under the intestacy laws, and possibly certain other trusts established in similar circumstances and for the same beneficiaries, we are considering allowing the trustees to elect that the children be treated as the owners of the trust assets. We think any such election would have to be once and for all to avoid it being exploited, would apply until the children reached the age of majority, and should not be treated as a disposal for CGT purposes.

19. We would welcome views as to whether the idea of an election for the beneficiary's tax position to govern the trust's tax status is considered useful and workable. An intestacy trust ceases when the orphan reaches 18, and so we think the tax benefits of such a trust should also cease at that point. We

would welcome views as to what trusts besides intestacy trusts should be included and how we should define these, by whom should the election be made, what should happen if there is a beneficiary who meets the requirements but is a beneficiary of two or more trusts, and so on.

Trusts for disabled people

21. We think that certain general trusts created for disabled people could also elect to be treated as though the beneficiary owned the assets within the trust. This election would also be once and for all, and would not be treated as a disposal for CGT or IHT purposes. The election could perhaps be made by the trustees and the disabled person, or by their legal representative.

22. Our starting point for defining which trusts would be allowed to make this election could be the definition of disabled trusts in Section 89 of the Inheritance Tax Act 1984 (see Appendix 1).

23. We would envisage all gains and losses being treated as the beneficiary's for CGT purposes. The disabled individual would therefore have their AEA available to set against the gains, could set losses against them, and so on.

24. If the disabled person put assets into such a trust the transfer would not count as a disposal for CGT purposes (and so would not restart the taper clock). Transferring assets out of the trust would not be treated as a disposal if they were transferred to the beneficiary who was already being treated as owner. However a transfer to someone else would be a disposal by the beneficiary. On the death of the disabled person the CGT death uplift would apply.

25. The trust as such would get no annual exempt amount, as the beneficiary would already have their own AEA, and the trust would not count as a trust for the purposes of restricting the AEA of other trusts which had the same individual as the settlor.

26. Again, we would like to hear views as to the potential benefits of such an approach, what problems we could encounter in practice, for example if the trust ceased to qualify, and also ideas as to how best such a system might be made to work.

Settlor-interested trusts

27. If we are to move towards a more tax neutral system in which the amount of tax chargeable on disposal of an asset does not greatly vary, depending on whether it is held via a trust or directly by an individual, changes in the current CGT rules would be needed. However, these may not be easy to introduce or simple to operate in practice.

28. Under the current rules the chargeable gains of settlor-interested trusts are chargeable on the settlor, not the trustees. But;

- unused trust losses are not available to be set against the settlor's non-trust chargeable gains and must be carried forward for set off against future trust gains;

- the conditions for various CGT reliefs are different for individuals and trustees;

- the taper rules take no account of the fact that an asset may have been transferred to the trust by the settlor. Gains attract increased taper relief in accordance with the time an asset has been held but the holding period of an asset before transfer by a settlor to a trust does not count towards the trust's qualifying holding period, even though it might be considered that the asset had remained in the same effective ownership.

29. Arguably the differences in CGT treatment are a consequence of a voluntary act to transfer assets to a separate legal person, the body of trustees. But there may be a case for treating all chargeable gains and allowable losses of a settlor-interested trust as accruing to the settlor and applying the same CGT rules as for a bare trust.

30. This approach would have the advantage of making a clear distinction between the treatment of settlor-interested and other, general, trusts. But there may be drawbacks for existing settlor-interested trusts. For example private residence relief would not be available on properties occupied by a beneficiary of the trust, except where the beneficiary in occupation was also the settlor.

Estates

31. Personal representatives do not pay income tax at the RAT, and the current legislation in Part XVI ICTA 1988 does provide for beneficiaries to be charged only on income passed on to them. However, personal representatives are liable to CGT at the RAT and we would like to consider whether there is potential for extending the flow-through treatment for streamed chargeable gains to estates.

32. Estate beneficiaries who have the proceeds of sale passed on to them could be treated as though they had disposed of an asset, or their share of it. The personal representatives would pay tax at the RAT on such gains, but the tax would be adjusted to the beneficiaries marginal rate of tax on their share of the gain. As for trusts, we think this could only work if the beneficiary received the proceeds of the gain within a certain time scale, again either the end of the tax year in which the gain was realised, or in certain circumstances early in the following year.

33. An alternative approach might be to provide for personal representatives and beneficiary concerned to elect to be treated as though the asset disposed of had been transferred to the latter immediately before the

disposal. Such an election could work in a way similar to Section 171A TCGA 1992, which deals with gains realised within groups of companies. We would welcome views as to the worth and workability of these options.

Inland Revenue Trusts
17 December 2003

APPENDIX 1

Section 89 Inheritance Tax Act 1984

(1) This section applies to settled property transferred into settlement after 9th March 1981 and held on trusts-

(a) under which, during the life of a disabled person, no interest in possession in the settled property subsists, and

(*b*) which secure that not less than half of the settled property which is applied during his life is applied for his benefit.

(2) For the purposes of this Act the person mentioned in subsection (1) above shall be treated as beneficially entitled to an interest in possession in the settled property.

(3) The trusts on which settled property is held shall not be treated as falling outside subsection (1) above by reason only of the powers conferred on the trustees by section 32 of the Trustee Act 1925 or section 33 of the Trustee Act (Northern Ireland) 1958 (powers of advancement).

(4) The reference in subsection (1) above to a disabled person is, in relation to any settled property, a reference to a person who, when the property was transferred into settlement, was –

(a) incapable, by reason of mental disorder within the meaning of the Mental Health Act 1983, of administering his property or managing his affairs, or

(b) in receipt of an attendance allowance under section [64 of the Social Security Contributions and Benefits Act 1992 or section 64 of the Social Security Contributions and Benefits (Northern Ireland) Act 1992, or

(c) in receipt of a disability living allowance under section 71 of the Social Security Contributions and Benefits Act 1992 or the Social Security Contributions and Benefits (Northern Ireland) Act 192 by virtue of entitlement to the care component at the highest or middle rate.