

MODERNISING THE TAX SYSTEM FOR TRUSTS

Discussion paper – Income Tax issues

1. This paper is concerned with particular measures to modernise the taxation of income arising to trustees. The three main measures we would like to explore are:

- Exempting income from the rate applicable to trusts/the Schedule F trust rate (referred to here as 'the RAT') when it is rapidly passed on to beneficiaries.
- Introducing a “basic rate” band for discretionary and accumulation trusts.
- Allowing the beneficiaries of certain trusts established for the vulnerable to be treated for Income Tax purposes as though they were the owners of the underlying assets.

2. 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. So 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.

3. The paper also covers a number of other issues affecting the Income Tax treatment of trusts, including trust management expenses, flat management trusts, and the tax pool.

Current system

4. At present, regardless of whether it is accumulated or distributed, income arising to the trustees of a discretionary or accumulation trust is chargeable:

- On Schedule F type income at the Schedule F trust rate of 25% (32.5% from 6 April 2004).
- On other income at the rate applicable to trusts of 34% (40% from 6 April 2004).

5. Trustees may have power to accumulate the income so that it becomes additional capital of the trust. If they later distribute some of the accumulated

income to the beneficiaries, that payment is a capital distribution, as opposed to an income distribution. Beneficiaries are not taxed on these capital payments, and receive no credit for the tax paid by the trustees. The tax paid at the RAT is therefore the final liability on this income.

6. As the RAT has been a compromise, set somewhere between the basic and higher rates of tax, this has tended to benefit higher-rate taxpayers, who suffer tax at the RAT instead of at higher rate on their income. Equally, it has tended to penalise basic rate or non-taxpayers, who would not have paid so much tax had they received the income direct. This paper considers ideas aimed at minimising the effect of raising the RAT for basic rate or non-taxpayers.

7. When income is not accumulated, but is instead passed by the trustees to the beneficiaries of the trust, the beneficiaries pay tax on the income at their own marginal rate and receive a tax credit at the rate applicable to trusts. If the tax paid exceeds the beneficiaries' liability they are able to claim back some or all of it.

Possible treatment of streamed income

8. We would like to know what people think of altering the treatment of income that arises to trustees of discretionary and accumulation trusts and is passed rapidly on to trust beneficiaries. In such circumstances, there may be a case for exempting the trustees from the RAT, and instead taxing them at no more than basic rate on this income.

9. We think that income passed on to beneficiaries in the same year it is received by the trustees could qualify for the exemption. If it is received right at the end of the tax year and is passed on to beneficiaries at the start of the next tax year it might be possible to still give the benefit of the exemption to trustees. Equally, there could be some sort of matching between the exemption from the RAT for the trustees and the receipt of the income by the beneficiary, so that the exemption only applies when the receipt is taxed in the hands of the beneficiary.

10. Trustees receiving such income either net of tax (such as Bank and Building Society interest) or with an associated tax credit (such as dividend income), would have no further tax to pay. When the income was passed through to the beneficiaries, they in turn would pay tax at their own marginal rate, with credit for the tax suffered by the trustees to set against their own liability as though the income had arisen to them directly.

11. Trustees who received income gross and passed it rapidly through to beneficiaries would pay no more than basic rate tax. Again, the beneficiaries would be liable at their own marginal rate on the income, but with a credit for the tax paid by the trustees. This would largely mirror the current Income Tax regime for trustees and beneficiaries of interest in possession trusts.

12. One of the issues to be considered with this proposal will be the effect on the tax pool. This is discussed in the “Tax pool” section below.

Basic rate band for discretionary/accumulation trusts

13. Although we are able to suppress the issue of Self Assessment (SA) returns where there will be no tax due from the trustees, this is not so for cases where trustees have very little tax to pay. In such cases, trustees have to complete and send in a return, and the Inland Revenue in turn has to process it.

14. One way to improve this situation would be to have a basic rate band for all trusts liable to the RAT. For example, the first £500 of trustees’ income might be taxed at only the basic, lower or dividend rate. Then, in trusts where income is under £500, there would be no further liability if the trustees received the income under deduction of tax or with an associated tax credit. This would also ensure that small trusts paid tax at no more than the basic rate, rather than the RAT.

15. We do not think it would be appropriate to remove these trusts from SA altogether, as we need to monitor levels of income arising to those trusts and paid out to beneficiaries. We also need to check on potential Capital Gains Tax (CGT) liability. So we could suppress the issue of returns for a number of years, but issue a return, say, every third year to minimise administrative burdens while still allowing us to make a periodic check. We would also have the right to issue a return where we had a particular reason for wishing to do so (for example, where we had received information about a potential liability to tax).

16. With a basic rate band, there would be issues with the tax pool. It is conceivable that there would be beneficiaries of discretionary trusts where the income had suffered tax at a mixture of basic rate and the RAT. We think it would be preferable to keep the tax in the tax pool as a single non-streamed block, so that when payments were made to beneficiaries there would be no need for complicated calculations showing the source of that income and the tax paid on it by the trustees.

17. The basic rate band might also mean that there would be insufficient tax in the tax pool to cover the tax credit given to a beneficiary. And so the trustees would have to pay more tax to cover that credit, which would detract from the aim of simplicity and easier self-assessment. We would like to hear views about the possible merits of the basic rate band, its impact on the tax pool, and its interaction with the income streaming measures discussed above.

Tax pool

18. The tax pool is unique to discretionary/accumulation trusts and is complex to understand and operate. The basic proposition is simple; if trustees suffer tax

on income they receive then, when that income passes out to beneficiaries, the beneficiaries should receive credit for the tax paid by the trustees. However, differing tax rates, trust management expenses and particularly non-payable tax credits can make the tax pool very complex.

19. We would like to consider the possibility of getting rid of the tax pool system altogether. Clearly this would give rise to issues around how much (if any) tax credit beneficiaries would receive when a payment was made to them from a discretionary/accumulation trust, and how we would deal with existing balances in tax pools.

20. If the income streaming suggestions outlined above were adopted, then many of the tax pool-related problems would be reduced. If income could flow straight through a discretionary trust, retaining its character and any attached tax credit as it went, then the tax pool becomes unnecessary for that income. It would only remain relevant for income received in a particular tax year but not paid out within the rapid payment time limit.

21. Equally, the basic rate band idea floated above could lead to increased complexity in terms of the different streams of tax entering the tax pool. Leaving aside the problems of uncertainty over accumulation, there will be a period of time during which income remains income and could therefore be paid out as income. Allowing that means you need a tax pool or some way of allowing income to retain its identity whilst held in the trust. We would be interested to hear people's views on the merits of changing the tax pool system in the light of the suggestions for income streaming and a basic rate band for trusts.

Trusts for the vulnerable

22. We think that the measures outlined above should make the tax system simpler and fairer for many beneficiaries of discretionary and accumulation trusts. However, the Government wants to ensure certain classes of vulnerable beneficiary pay less tax. Some trusts for these groups have to accumulate income and will therefore be liable to income tax at the RAT.

Orphaned children

23. Trusts created on the death of a child's parents, either under the provisions of a will or under the rules of intestacy, may provide for funds to be accumulated for the benefit of the orphaned child or children. Such trusts are relatively rare, as it is very unusual for children to lose both parents whilst they are under 18.

24. The funds in such a trust are needed to support and maintain the children as they grow up, but not all of the income will have to be applied for the children's benefit in any given year. This would mean that the income would be

accumulated, and the ideas above for exempting income from the RAT would not apply, so the income arising to the trustees would be liable at the RAT. We would like to take views as to whether it would be right to provide for special treatment for such trusts.

25. One way of addressing these concerns would be to allow an election to deem such trusts to be settlor-interested trusts with the children treated as the settlor. The children could then use their personal allowance, starting and basic rate bands, etc. against any income without that income having to be released to them. The trustees would have to account for the tax and they would still maintain control over the trust funds and be able to prevent the child from accessing the funds until such time as the trust deed permits. We would like to hear views as to whether this possible solution is workable and worthwhile.

Trusts for disabled people

26. The considerations affecting trusts for orphaned children may also affect trusts created for disabled individuals. These trusts are established for the long-term benefit of the disabled person, and generally it would not be desirable for trustees to pay out all the income received in any one year. The income that is not paid out in the year will suffer tax at the RAT unless we make special provision for it.

27. Trusts for the disabled may be set up by parents (or other relatives) for their child, or alternatively might be created with damages from an insurance company or hospital following an accident. In the case of the latter, the trust would usually be treated as settlor-interested with the disabled individual as settlor.

28. We think it would be possible to treat all trusts established for the benefit of disabled people as settlor-interested for Income Tax purposes. We would need to define such trusts but think a good starting point would be the definition of disabled trust provided by Section 89 of the Inheritance Tax Act 1984.

29. Many modern settlements for injured people are in the form of “structured settlements”. These provide for regular payments over the life of the injured person, and these payments are exempt from tax. We see no reason to change these rules.

OTHER ISSUES

Trust management expenses

30. Trust management expenses (TMEs) are expenses incurred by trustees in the administration of their trust duties. They are separate and distinct from the expenses incurred by a trader, or incurred in the course of a Schedule A

business (both of which can also be incurred by trustees engaged in such activities, and are deductible in arriving at the measure of their income from such sources).

31. We have recently reviewed the tax treatment of TMEs in detail and it is clear that there is widespread confusion about what TMEs actually are, and about the extent to which they are allowable for tax purposes.

32. Under current law there are in fact very few allowable TMEs as they only include expenses of the trustees that are properly chargeable to income. For example, expenses are not TMEs if they are not expenses *of* the trustees - an example would be trustees' fees. And expenses are not TMEs if they are not properly chargeable to *income*. In a discretionary trust, expenses are almost exclusively for the benefit of the trust as a whole, and so are capital in trust law. To be properly chargeable to income they must be paid exclusively to husband the income of the trust.

33. We have seen that many items of expenditure being claimed as TMEs are in fact distributions made by trustees rather than expenses. Sums laid out by trustees of an employee benefit trust, for example, to fund visits to deserving former employees who are beneficiaries of the trust, are distributions and not expenses.

34. We believe that there is a need to codify in statute what expenses are allowable for tax purposes for trusts. We would like to hear views as to the merits of these proposals.

35. Some of the comments above apply equally to expenses incurred by personal representatives. If it is felt that there is a need to clarify the legislation for TMEs we think it would be sensible to do the same for personal representatives.

Capital items

36. We have various provisions that tax certain receipts which are capital in trust law as income for Income Tax purposes. The legislation for these items works in different ways, and this can lead to inconsistency in how the provisions apply. We propose to bring the mechanism for charging such items to the RAT together into one common provision to make their taxation simpler and more consistent.

Dividend income

37. We believe that reducing the number of rates that apply to trust income would assist in making the tax system easier for trustees. We are therefore considering charging an appropriate proportion of trustees' dividend receipts at

40% and abolishing the separate 32.5% rate. The aim would be to arrive at the same final tax bill as would have been the case had the rate stayed as it is now. We would like to hear people's views on this proposal.

Income arising to beneficiaries of settlor-interested trusts

38. We think there is a case for changing the treatment of income arising to settlor-interested trusts in the hands of the beneficiary. At present, this income is assessed under Case VI of Schedule D, and is taxed on the beneficiary at basic rate and higher rate depending on the beneficiary's circumstances, even in circumstances where it would have been assessable at a different rate (e.g. the savings rate) if received direct. We think that providing for income to retain its character as it flows through the trust will remove a source of inconsistency in the tax system for these trusts, and would like to hear people's views on whether this proposal is considered beneficial, what any drawbacks would be, and whether there are ways of minimising these.

Flat management trusts

39. Flat management trusts, or flat management companies, exist generally to collect funds to pay for the maintenance of communal buildings such as blocks of flats. Under the Landlord and Tenant Act 1987 some such funds are required to be held in trust. In addition many residents chose to create a trust to hold funds even where the Landlord and Tenant Act does not apply.

40. Many residents of blocks of flats who are not higher rate taxpayers feel it is unfair that the funds held in the trust are taxed at the RAT when they themselves are taxed at a lower rate. Of course, the funds are placed in trust in order to ensure they are available to pay for necessary expenditure, and so they are in quite a different position to sums that the residents might hold for their own benefit.

41. The vast majority of flat management trusts receive only small amounts of income in a year and currently have to complete a SA return to pay small amounts of tax. We think that the proposed basic rate band for trusts will ensure that the vast majority of these trusts will be kept out of SA thus reducing compliance burdens but we would welcome views as to the effectiveness of this.

Inland Revenue Trusts
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