

## **MODERNISING THE TAX SYSTEM FOR TRUSTS**

In his Pre-Budget Report on 10 December 2003, the Chancellor announced plans to modernise and simplify the Income Tax and Capital Gains Tax system for resident trusts. There will be discussions involving representative bodies and the public about possible changes, with the aim of introducing the new system from April 2005.

### **Details**

These modernisation proposals are for family / personal types of trust, not unit trusts, Venture Capital Trusts or other specialised vehicles that whilst called trusts have their own separate taxing system or are taxed as corporations.

Trusts are within the Self Assessment regime for the purposes of Income Tax and Capital Gains Tax but are taxed according to a different set of rules.

The current tax system for trusts is complex. This is because trusts are complex entities that blur the ownership of assets, but it is also because the existing rules have developed over time in a piecemeal way.

A large proportion of trusts receive only small amounts of income. Often such trusts may have been established under the terms of a deceased person's Will, or to protect the assets of an incapacitated or vulnerable person. At the other end of the income scale, there are many very large trusts, including some specialised trusts such as Employee Benefit Trusts.

There are separate rates of tax applying to the income and gains of certain trusts. The existing Rate Applicable to Trusts (RAT) of 34% was chosen as a compromise designed to reflect the fact that some trust beneficiaries will be basic or lower rate taxpayers, whilst some others will be liable at the higher rate. But the result is that for any individual beneficiary, the rate of tax paid often differs from their marginal rate if assets are held via a trust.

A key aim of modernising the tax system for trusts is to improve fairness by reducing the distorting effects of holding assets in a trust rather than directly. Increasing the RAT to 40% is part of that. A modern tax system for trusts will deliver benefits for all trusts, but in particular the Government wants to reduce tax and compliance burdens on smaller trusts and trusts established to protect vulnerable people.

There will be a series of discussions about possible changes with Inland Revenue officials taking views from representative bodies and others involved in the trust sector. The process will start from the Pre-Budget Report and will continue through to Spring 2004.

The discussions will take place in London, Edinburgh and Belfast, to allow as many people as possible to contribute, taking account of the variations in the legal systems in different parts of the United Kingdom.

A number of discussion documents will be issued on 17 December 2003 to inform those discussions. The proposed timetable is:

<b>DATE</b>	<b>ITEM</b>	<b>DESCRIPTION</b>
10 December 2003	Pre-Budget Report	<ul style="list-style-type: none"> <li>• Modernisation plans announced.</li> </ul>
17 December 2003	Discussion papers issued	<ul style="list-style-type: none"> <li>• Invite comments from interested parties.</li> </ul>
7 January 2004	Discussion Meeting 1 – Somerset House, London	<ul style="list-style-type: none"> <li>• Discuss reducing/harmonising the various definitions, types of trusts and residence tests. Plus ideas for changes to income tax and Capital Gains Tax and settlor interested tax system.</li> </ul>
14 January 2004	Discussion Meeting 2 – Somerset House, London	<ul style="list-style-type: none"> <li>• Ditto meeting 1.</li> </ul>
22 January 2004	Discussion Meeting 3 – Somerset House, London	<ul style="list-style-type: none"> <li>• Ditto meeting 1.</li> </ul>
28 January 2004	Discussion Meeting 4 – Somerset House, London	<ul style="list-style-type: none"> <li>• Ditto meeting 1.</li> </ul>
3 February 2004	Discussion Meeting Meldrum House, Drumsheugh Gardens, Edinburgh	<ul style="list-style-type: none"> <li>• Ditto meeting 1.</li> </ul>
5 February 2004	Discussion Meeting Europa Hotel, Belfast	<ul style="list-style-type: none"> <li>• Ditto meeting 1.</li> </ul>
18 February 2004	Deadline for written responses	<ul style="list-style-type: none"> <li>• Written responses due.</li> </ul>
Budget 2004	Publish proposals	<ul style="list-style-type: none"> <li>• Announce outline of modernised system.</li> <li>• Publish summary of responses to discussion documents.</li> </ul>
PBR 2004	Publish draft legislation	<ul style="list-style-type: none"> <li>• Draft legislation published to allow time for comments.</li> </ul>
Budget 2005	Publish proposed final legislation	<ul style="list-style-type: none"> <li>• Legislation will still need to be approved by Parliament.</li> </ul>
6 April 2005	New system starts	<ul style="list-style-type: none"> <li>• New rules start.</li> </ul>
April 2006	First SA returns	<ul style="list-style-type: none"> <li>• SA returns issued for new system.</li> </ul>

## **Proposals for a Modern Income Tax and Capital Gains Tax System for Trusts**

We would like to hear any ideas for modernising the tax system for trusts. Below we have set out the areas we think need to be discussed and some possible answers but that is simply to get the debate started, we are willing to consider any suggestion that simplifies the system. We will be issuing detailed discussion papers on these areas on **17<sup>th</sup> December** so what is set out below is only a brief outline:

### Definitions of trust and settlement

We would like to explore the possibility of reducing the number of definitions we have within the tax system for some common trust-related terms. At present there are several different approaches to taxing trusts or settlements, depending on the different tax involved and the particular definitions which apply. We have three different definitions of “settlement” and nine different definitions of “settlor interested” trust in the Taxes Acts. Creating fewer and clearer definitions would be less confusing and reduce the scope for error.

### Residence test for trusts

We would like to explore the possibility of creating a single test for trust residence for Income Tax and Capital Gains Tax, building on the residence test for individual trustees and settlors. We would like to know how interested parties would view the creation of a single residence test for trusts.

### Basic rate band

We are considering the possibility of introducing an income tax basic rate band for all trusts. This would particularly benefit those trusts which only receive a small amount of income. We envisage income below the trusts basic rate limit would be taxed only at the Schedule F ordinary rate, lower rate or basic rate depending on the nature of the income

The Government is keen to reduce compliance burdens on small trusts, and a basic rate band applying to the first slice of income would mean many of them would not have to complete a Self Assessment return every year. We would like to hear views on whether a basic rate band should apply to all trusts liable to the RAT, at what level the cut-off point should be set, whether there should be a tapering-off of the relief above the basic rate limit, and whether basic rate is the most appropriate rate at which to charge the income of such small trusts.

### Flow through of income & gains

We are also considering an exemption from the RAT for most trusts where income and capital gains are passed quickly through to the trust’s beneficiaries. Such income and gains would of course be taxable on those beneficiaries at their marginal rates of tax.

We would like to explore the benefits of such a measure, and to discuss how it might work in practice, whether it should apply just to income and gains distributed in the year itself, or whether we should extend the treatment to income and gains passed on within a particular period after the year end.

### Trusts established for disadvantaged groups

We would like to explore the possibility of allowing the beneficiaries of certain trusts (such as those for the disabled and for orphaned children) to elect to be treated as if they were the owner of the assets in the trust. This would mean that for tax purposes we would tax the beneficiary as if they received the income and gains direct.

### **Background on current system**

The tax system for trusts is very complex. Trustees and the Inland Revenue have to cope with:

- Over 20 different kinds of trust.
- Different rules for whether a trust is resident.
- Different definitions of what constitutes a “trust” or “settlement” for the different taxes.
- Definitions of income, allowable expenses, the type of trust and even whether a trust exist that rely heavily on trust law.
- Many separate tests for whether a trust is settlor-interested again with variations depending on the tax.
- 5 different income tax rates for discretionary trusts.
- The absence of a nil rate band for income tax so that over three-quarters of trusts have to fill in an SA return each year even though their income is often small.
- Churning in discretionary trusts so that over a quarter of income taxed in the trust requires a further payment or a repayment when passed out to beneficiaries, plus a system for calculating tax credits (the “tax pool”) on distributions that can require records to be kept for a string of years.

In the current tax system the broad approach for resident personal trusts is to tax the settlor or beneficiaries where it is reasonably easy to link them to the trust and to tax trustees where a link cannot be made.

Thus where a **settlor** retains an “interest” in a trust the aim is to treat them as if they still owned the assets:

- The income of the trust is included as part of the settlor’s income for income tax if the settlor or their spouse (or minor unmarried child) could benefit from the

trust. Some tax may be collected by the trustees, but this is taken into account in calculating the individual's tax bill. For CGT an amount equal to the chargeable gains is added to the settlor's chargeable gains if they or their spouse could or do benefit from the trust.

The **beneficiary** is taxed where they receive income from the trust:

- In the case of a bare trust, income tax and CGT are charged as if the beneficiary had received the money direct.
- In the case of an Interest in Possession (IIP) trust, the income of the trust less management expenses is treated as the beneficiary's income for income tax. The trustees will usually pay tax on income received before deduction of tax, but the beneficiary can claim credit for this. The income also retains its character as interest, dividends, etc. when it passes through the trust.
- In the case of a discretionary trust, trustees are liable to pay tax on income less management expenses at the Rate Applicable to Trusts (RAT) of 34 per cent (25 per cent for dividends). If this is then distributed as income, either in-year or subsequently, it is taxed as part of the beneficiary's income. A credit is given for the tax paid by the trustees out of a tax "pool". The distribution is treated as a different source of income (Case III Schedule D) to that received by the trustees. It does not retain its character as dividends, interest, etc.

Where the income or assets cannot readily be identified with settlors or beneficiaries, tax is levied on the **trustees** at special rates and with special reliefs:

- Income retained in a discretionary trust and accumulated as capital is taxed at the RAT, as are capital gains in all trusts. This tax liability is final. If the capital is distributed there is no adjustment to take account of the tax position of beneficiaries. The level of the RAT – 34 per cent – is not based on a set formula. But in effect it is a compromise to reflect the fact that some beneficiaries/settlors will be 40 per cent payers and others will be basic rate, 10p or non-taxpayers.
- Trusts are not given a personal allowance for income tax, but can claim various expenses. Trusts are given an Annual Exempt Amount (AEA) for CGT that, subject to conditions, is half that for individuals. This is again a compromise to reflect the fact that some beneficiaries will have gains of their own while for others the trust will be their only source of gains.
- Transfers in and out of trusts are treated as disposals for CGT, but holdover relief may be available on business property and for discretionary trusts where the transfer is chargeable to IHT.

This approach is applied to the bulk of resident personal trusts irrespective of their size or nature. But some trusts are given more favorable treatment, for example:

- Some trusts for the disabled are entitled to a full individual AEA for CGT.

- Heritage Maintenance Funds (HMFs) for historic buildings can opt out of the settlor-interested rules and have income taxed at the RAT in the trust.

There are special rules for taxing chargeable event gains from life insurance policies held on trusts. These will also be considered as part of the discussions on a modern tax system for trusts.

## **Contacts**

All individuals and organisations sent a copy of this paper will automatically be sent the discussion papers on 17<sup>th</sup> December and invited to the discussion meeting in January or February 2004. If you obtained a copy of this paper indirectly, or from the internet, and would like to receive copies of the discussion papers, or attend the discussion meetings, please contact:

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Or fax on 020 7438 8342.

The deadline for written responses to the discussion papers is Friday 18<sup>th</sup> February 2004. It is not possible to give the usual 12 weeks for comments due to time constraints and the need to have proposals ready to announce in the 2004 Budget.

Responses to the discussion papers, together with the names and addresses of respondents, may be published unless confidentiality is specifically requested. We will assume that if you are replying by e-mail, any confidentiality disclaimer that is generated by your organisation's IT system is overridden unless you specifically include a request to the contrary in the main text of your submission to us. Please note that any confidentiality cannot be guaranteed where a response includes evidence of a serious crime.