

# MODERNISING THE TAX SYSTEM FOR TRUSTS

## OVERVIEW OF THE PROPOSALS

1. The Government has asked the Inland Revenue to discuss with trust professionals, representative bodies and other interested parties ideas and options for modernising the income tax and capital gains tax system for UK resident trusts. The Inland Revenue paper of 11<sup>th</sup> December set out some of the initial ideas for discussion. We are keen to hear what people think of these ideas and would also like to hear other ideas to improve the current tax system for trusts. With this paper are three discussion papers setting out in more detail some of our ideas and suggestions. These are open-ended papers intended to stimulate debate, and should not be read either as firm proposals, or as the only options for consideration.

### Scope of the review

2. These modernisation proposals cover all types of UK resident personal trusts. That includes service charge and sinking fund trusts created by the Landlord and Tenant Act 1987, employee benefit trusts and trusts that hold life insurance products as well as the normal family type trusts. The focus of the review is not on offshore trusts or authorised unit trusts, or other specialised vehicles that have their own separate taxing system or are taxed as corporations. We recognise that changes to the tax system for resident trusts might mean some consequential changes are needed elsewhere but we will consider those when the shape of the new system is clearer.

### Government Objectives

3. When considering the ideas put forward in the attached discussion papers, and other ideas you might have, it is important to bear in mind what the Government wants a modern tax regime for trusts to achieve.

4. 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. 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. Neither does it want to penalise beneficiaries where a trust exists to protect the vulnerable, such as a disabled person. 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.

5. Taking all this together implies a tax system that is broadly similar to what we already have but improves upon it. It should remove distortions and unnecessary burdens when trusts are not being used to avoid tax. As far as possible we should aim to tax the person benefiting from the trust where that person can be identified. So the principles to aim for are:

- The tax system should be as simple and easy to understand as possible.
- Complying with tax obligations should be straightforward.
- Where a beneficiary receives income or benefits from a trust they should be taxed as if they received them direct.
- Where a settlor retains an “interest” in a trust they should be treated as if they still owned the assets.
- Where the income or assets cannot readily be identified with settlors or beneficiaries, tax should be levied on the trustees.
- Trustees with little income and no gains should not have to complete Self Assessment (SA) returns every year.
- Trusts set up to protect the vulnerable should receive special treatment.
- Anti-avoidance legislation is appropriate for those who use trusts to avoid tax.

### **An example of a modern tax system for trusts**

6. Applying these broad principles to the present tax system, with the ideas and suggestions floated in the accompanying discussion papers, helps us to form a view of a possible modernised tax system for trusts. To assist in the discussion, we have set out below an example of what a modernised tax system could look like. This is not intended to be a comprehensive description of a revised regime, nor is it the definitive answer. It is intended to indicate in broad terms how one possible version of the system might work. We hope it is helpful to draw things together in this way so people can see one possible overall picture.

7. In many cases the rules would be the same as they are now but these are repeated below for completeness. Also in some instances below we have set out options rather than one particular model. This is simply to demonstrate how a number of different options could fit within this overall framework.

### **Definitions**

8. If possible there would be a common definition of settlor, settlement (trust) and settlor interested trust. There would have to be variations on the common definitions to prevent avoidance but trusts not being used to avoid tax would have one set of simple definitions. There would also be one common residence test for trusts.

9. Harmonising the settlor-interested tests would in some contexts necessarily widen the scope of a new test beyond what is covered now. However with a rate

applicable to trusts of 40%, being settlor interested would reduce the tax paid in many cases.

10. For income tax and capital gains tax (CGT) purposes trusts would be divided into three categories; settlor-interested trusts, bare trusts and general trusts. Within the third “general trusts” category certain trusts would get, or be entitled to elect for, a different tax treatment in certain circumstances.

### **Settlor-interested trusts**

#### *Income Tax*

11. All the income arising to a settlor-interested trust would be treated as the income of the settlor. The income would retain its character, so rent would be taxed as rent, bank interest as bank interest, etc. The trustees would pay tax at the rate applicable to trusts (40% from 2004-05, under the proposal announced in the 2003 Pre-Budget Report) on all trust income. The settlor would reclaim any tax not due through Self Assessment or the claims system. As now there would be no deductions for Trust Management Expenses (TMEs).

12. Payments of income out of the trust to beneficiaries other than the settlor would be treated as a gift by the settlor to the beneficiary.

13. Reliefs due to an individual, such as for charitable giving, would be available to the settlor in respect of funds paid out from the trust.

#### *Capital Gains Tax*

14. All gains and losses would be treated as the settlor’s for CGT purposes . So trust losses could be set against personal gains and vice versa. Putting assets into a settlor-interested trust would not be treated as a disposal or acquisition and would not restart the taper clock.

15. Transferring assets out of the trust would not be treated as a disposal if they were transferred to the settlor. However a transfer to someone else would be treated as a disposal by the settlor.

16. The trust would get no separate annual exempt amount (AEA). The settlor would be able to use their own AEA. The trust would not count as a trust for the purposes of restricting the AEA of other trusts made by the same settlor.

17. This regime would have implications for a variety of CGT reliefs. For instance, the circumstances in which assets of a settlor-interested trust should be counted as business assets for taper relief purposes would need to be reviewed. And private residence relief (PRR) would be due only if the settlor occupied a property owned by the trust as their only or main residence.

18. The trustees would pay tax at the rate applicable to trusts (40% from 2004-05, under the proposal announced in the 2003 Pre-Budget Report) on all trust gains and the settlor would be able to reclaim any tax not due.

## **Bare trusts**

### *Income Tax*

19. The absolute beneficiary would be taxed on the income arising as if the trust did not exist. The trustees would not be obliged to pay income tax on behalf of the beneficiary. At present some bare trusts choose to self assess, usually where this makes agreeing the amount of the income easier than dealing with a number of tax offices for all the beneficiaries. The Inland Revenue also issues SA returns to some bare trusts either for compliance purposes or where there is an administrative benefit from doing so. Those arrangements would continue.

### *Capital gains Tax*

20. The current CGT position would continue. Gains would be taxed on the absolute beneficiary as if the trust did not exist. The trustees would pay no tax on behalf of the beneficiary. Creating or ending the trust would not restart the taper clock or be treated as a CGT disposal unless the “owner” of the assets changed. So a transfer by Mr Andrews into a bare trust for the benefit of Mr Smith would be a chargeable event. But a subsequent transfer by the trust to Mr Smith would not.

21. The trust would get no AEA. The beneficiary has their own AEA. The trust would not count as a trust for the purposes of restricting the AEA of other trusts made by the same settlor.

22. PRR would be available only if the absolute beneficiary occupied a property owned by the trust and all other conditions were met.

## **General trusts**

23. General trusts would include discretionary trusts, accumulation trusts and interest in possession trusts all taxed under a common regime. The tax treatment for interest in possession trusts would be largely as it is now but having a single set of rules would simplify things and mean that for tax purposes the distinctions become less important.

### *Income Tax*

24. All income, and deemed income for tax purposes, arising during a year would initially be taxed at the Schedule F ordinary rate, the lower rate or the basic rate as appropriate. Where a beneficiary became entitled before the end of the year to that income, or where they were entitled to the income as it arose – an interest in possession - then the income would flow through the trust to the beneficiary. So bank interest of £100 from which tax of £20 had been deducted flows into and out of the trust as bank interest and the tax of £20 would be repayable if the beneficiary was not liable to tax.

25. It might be possible to allow discretionary income payments made within a short period after the end of the tax year, say the end of April, to flow through as in paragraph 24 above. We would then need to consider whether that income paid out after the end

of the year should be treated as the beneficiary's for the year in which they received it, rather than the year the trustees received it.

26. Where under the terms of the trust a beneficiary is entitled to a particular stream of income (an interest in possession trust), such as all the dividends, then the income they receive will be treated as dividend income. Where they are just entitled to income (from a discretionary trust) then we would need to decide how the income should be treated. We could continue to treat this as an annual payment or we could seek to maintain the nature of the income. The later presents identification problems where the possible options are to regard it as paid either;

- rateably out of the various sorts of income arising to the trustees, or
- first out of income with basic rate tax credit, next income with a lower rate credit and finally income with a Schedule F ordinary rate credit, or
- however the trustees chose.

27. Income, and deemed income for tax purposes, not paid out by the end of the tax year, or possibly the end of April, would be treated as accumulated. So much as exceeds a "basic rate band" would be taxed at the rate applicable to trusts of 40% or the Schedule F trust rate of 32.5%.

28. The basic rate band would need to be large enough to ensure that small trusts which received small amounts of income which has been taxed at source, could be kept out of SA – subject to a periodic check. A figure of £500 might be the right level and we expect there would have to be anti-fragmentation rules to prevent avoidance.

29. There are options for how subsequent payments funded out of accumulated income should be treated. We would welcome views on this but the options seems to be the accumulated income payments should;

- be treated as capital payments, or
- if made within, say, three years be treated as income, or
- in any case, always be treated as income.

30. The first option has the benefit of simplicity whereas the last two options would require some sort of tax pool or a method of identifying separate pools of income with similar tax credits. So if the gross income was £100 bank interest and the trustees pay £40 tax, then, either;

- the income loses its identity and the £40 goes into a tax pool (if at some later stage £60 is paid out that goes out as an annual payment with a tax credit of £40), or
- the £60 remains bank interest within the trust with a £40 tax credit. If at some later stage the £60 is paid out it goes out as £60 of bank interest with a £40 tax credit.

31. We recognise that there is a read across here to the IHT rules for trusts, given that the boundary between income and capital is also relevant there.

32. The rules for trust management expenses (TMEs) would be codified to ensure fair and consistent treatment.

### *Capital Gains Tax*

33. The trustees would be taxable on all capital gains at the rate applicable to trusts (proposed to be 40% from 2004-05). However if during the tax year, or possibly by the end of April following, a beneficiary became absolutely entitled to a trust asset or to all or part of the proceeds of a capital gain, then the gain, or part of it, would be taxed as the beneficiary's.

34. There would need to be rules to determine when the proceeds of a gain are treated as having been passed to beneficiaries and what to do when there has been more than one disposal during the year.

35. Where beneficiaries were taxable on capital gains in this way the question arises whether they should be taxed for the year in which the gain arose or, if later, the year in which they became entitled to the proceeds. We think the better approach would be to treat such gains as taxable in the year in which they arose.

36. Transfers into or out of the trust would be treated as a disposal and acquisition (including transfers out of a trust to a beneficiary) and the normal CGT rules for trust assets, such as business asset taper relief and gifts hold-over relief would apply.

37. In most cases trusts would continue to get half the full AEA for an individual, subject to the existing anti-fragmentation rules.

38. Private Residence Relief would be available only if a beneficiary occupied a property owned by the trust and all other conditions were met.

### **Specialist trusts**

39. There would be certain specialist trusts which could be treated differently to the above rules:

#### *Trusts for minor orphaned children*

40. Certain trusts could elect to be treated as settlor-interested trusts with the children treated as the settlor. These would be trusts;

- created on the death of a parent under the rules of intestacy for their minor children where absolute entitlement to the trust funds vests in the children at 18, or
- where a parent's will makes an unqualified bequest to their minor child at the time of their death and the Trustee Acts automatically creates a trust for as long as the child is a minor.

41. As discussed in the attached “Definitions” papers we would also need to consider whether certain other trusts for minor children created in a will could also make such an election. The election would be once and for all and would not be treated as a disposal for CGT purposes. The election would be made by the trustees, or could be made by the parent in the will.

42. This would reduce the tax paid on the trust assets to the children’s marginal rates thus achieving a significant Government objective.

#### *Trusts for disabled people*

43. Settlements for disabled people which take the form of “structured settlements” would continue to be exempt from tax as now under specialist legislation.

44. Certain general trusts created for disabled people could also elect to be treated as settlor-interested trusts where the disabled person would be treated as the settlor. The election would be once and for all and would not be treated as a disposal for CGT purposes. The disabled person or their legal representative could make the election.

45. The exact definition of trusts to which this option would be restricted needs to be decided but the existing CGT or IHT definitions of disabled trusts seem a good place to start.

46. The interaction with the various rules for Benefits and Tax Credits would need to be considered.

#### *Employee Share Option Trusts*

47. These trusts enjoy exemptions from income tax on some dividends plus some CGT exemptions or special treatment. These would remain.

#### **Scottish and Northern Irish trusts**

48. Scottish and Northern Irish trust law is different to the law in England and Wales. The new system would seek to ensure that for tax purposes there would be consistency of treatment across the UK, in order to provide greater clarity and reduce compliance costs. So Scottish and Northern Irish trusts would be taxed in the same way as English general, bare and settlor-interested trusts, depending on the category into which they fall.

#### **Estates in administration**

49. It might be possible to bring estates in the course of administration into the same tax regime as trusts. That is attractive as they use the same Self Assessment return as trusts and many estates provide for the creation of trusts anyway. It may be possible to achieve this by treating estates as “general trusts”. However there are issues with that, not least because payments out of an estate which are treated as income in the hands of beneficiaries can include capital payments. Also estates would lose some tax advantages, and gain others. The existing estate rules that seem to pose particular issues are:

- There is no limit between the time income arises to the estate and the time it can be paid out as income to beneficiaries.
- Estates get the full CGT AEA for an individual for the tax year in which a person dies and the two following years.
- Personal representatives are liable to tax at the rate applicable to trusts on all their chargeable gains.
- Different expenses rules apply.
- Payments out of capital by personal representatives can trigger income tax liability for beneficiaries.

50. We would welcome views on the desirability of taxing estates as if they were trusts in this way.

### **Administration and compliance**

51. Some of these proposed changes would significantly reduce administration costs. In particular:

- The small “basic rate” band for income tax.
- Common definitions and fewer types of trust.
- No / less of a tax pool.
- No / less churning.
- Clearer, more consistent rules would also help reduce errors and mistakes.

### **Advantages and disadvantages of such a new system**

52. It is recognised such a new system would produce some advantages and some disadvantages. That is inevitable when seeking to simplify what is a complex area of the tax code.

53. Disadvantages could include:

- Accumulated income and tax pools that can no longer be paid out many years after receipt as income.
- Widening the settlor interested test, although in some instances this is beneficial as it might lower the overall tax charge.

54. Advantages could include:

- A clearer, more logical system.

- The ability for income to flow through discretionary trusts.
- No / less churning.
- A new basic rate band.
- Many small trusts would not have to complete a SA return every year.
- The ability to offset personal losses and trust gains in settlor-interested trusts for CGT.
- The ability to pass capital gains out to beneficiaries of “general” trusts.
- Trusts for orphans and disabled people can elect for more favourable treatment.
- Clearer rules for TMEs.
- A possible continuous system for taxing estates and trusts making things easier for personal representatives / trustees.

55. We welcome comments as to whether a revised regime on the lines described above would be simpler and fairer.

### **Anti avoidance provisions**

56. As stated above we recognise that such a tax system for trusts would provide new tax avoidance possibilities. We would therefore need provisions to stop avoidance and some of those provisions would necessarily be complex. However the intention would be that for those not seeking to use a trust to avoid tax the system would be simpler and easier to comply with.

### **Summary**

57. We think it is possible to modernise the income and capital gains tax system for trusts to give a simpler fairer system for most trusts. Individuals using trusts to protect the vulnerable or to hold assets without attempting to avoid tax would enjoy a simpler system with lower compliance costs. Many trusts would pay less tax overall even after the increases in rates announced in the Pre Budget Report. However those seeking to use trusts to avoid tax would find the anti-avoidance provisions tougher than now and applying them could be complex.

58. Such a system would seem to meet the Government’s objectives but it is of course for Ministers and ultimately Parliament to decide the final shape of the new system.