

15 REGULATORY IMPACT ASSESSMENT FOR TRUST MODERNISATION

Purpose and Intended Effect of Measure

The Policy Objectives

15.1 The policy objectives of the Trust Modernisation package are to reform the income tax and capital gains tax (CGT) system for trusts, to provide greater consistency of approach between income tax and CGT in relation to the taxation of trusts, and, following on from measures introduced in the Finance Act 2005, to continue to reduce tax compliance burdens on smaller trusts.

15.2 The changes will apply to the whole of the UK.

Background

15.3 Finance Act 2004 increased the rate applicable to trusts (RAT) to bring it in line with the higher rate for income tax. However, since it was recognised that this could have an impact on smaller trusts, trusts with vulnerable beneficiaries and other trusts whose beneficiaries are not higher-rate taxpayers, Finance Act 2005 introduced a standard rate band for all trusts that pay tax at the dividend trust rate or the RAT and a new regime for certain trusts with vulnerable beneficiaries.

15.4 The Government recognise that the taxation of trusts can be a complex area and particularly challenging for non-professional trustees. The measures being introduced at Finance Bill 2006 (as impact assessed in the regulatory impact assessment) aim to align the main tests and definitions for income tax and CGT and, therefore, reduce the burden of administering the taxation of trusts.

Rationale for Government Intervention

15.5 The proposals will make the taxation of trusts more consistent across the income tax and CGT regimes and therefore reduce administrative burdens on trustees, especially the trustees of smaller trusts.

Consultation

15.6 A series of discussion papers was published in December 2003, setting out a number of initial proposals for modernising the taxation of trusts. This was followed by a consultation paper in August 2004. The summary of responses to the consultation was published on 16 March 2005, accompanied by a Regulatory Impact Assessment.

15.7 The Chancellor announced proposals for two new measures for modernising the tax system for trusts at Budget 2005. Legislation for these measures was included in the Finance Act 2005.

15.8 The Government also asked the Inland Revenue (now HMRC) to discuss further with interested parties some of the more detailed aspects of the proposals. The discussion paper was published on 16 March 2005. The summary of the responses was published on 31 January 2006.

15.9 As a result of discussion, draft legislation and explanatory notes for the measures being brought forward at Budget 2006 were also published on 31st January

2006, accompanied by a Partial Regulatory Impact Assessment, for comment. The deadline for responses to the draft legislation was 17th February 2006.

15.10 We received 32 responses to the draft legislation. There were some requests for the legislation to come into effect in April 2007, and some concerns expressed regarding the change to the settlor-interested rules for CGT (please refer to paragraph 15). Many respondents opposed this change on the grounds that it will stop parents who settle business assets on their dependent children claiming relief from CGT on the gift. In general, the remainder of the proposals were welcomed. Helpful contributions were received on several detailed aspects of the draft legislation.

Options

1. Do Nothing

15.11 Although this option was considered, given the commitment made by Ministers at the time of introducing the increase in the RAT, and the discussion and consultation that followed, this option has not been recommended.

15.12 In response to the discussion papers and in meetings with representative bodies, the proposed changes were welcomed and the consensus has been that these should, where possible, be taken forward as a package.

15.13 The do nothing option would mean that inconsistencies in the way we tax trusts would remain, and the further reduction in the administrative burden for small trusts which is one of the benefits of this package, would not be realised.

2. Summary of new legislation being introduced (chosen option)

15.14 Legislation for the measures outlined in the following paragraphs will be included in the Finance Bill 2006.

Increase in Standard Rate Band

15.15 This will be raised from £500 to £1000. Below this level, trustees' income will be assessable at no more than the basic rate of income tax (currently 22%), which means that many trustees whose income is taxed at source will have no additional tax to pay. Those trusts with income consistently below £1000 will no longer need to complete an annual Self Assessment return.

Common Meaning of Settlement

15.16 This will align what is treated as a settlement for the general purposes of income tax and tax on chargeable gains. The meaning of 'settlement', which will apply for both income tax and tax on chargeable gains will be that which currently applies for the purposes of the Taxation of Chargeable Gains Act 1992 (TCGA) except where the broader anti-avoidance meaning given in section 620 of the Income Tax (Trading and Other Income) Act 2005 specifically applies.

15.17 The effect is that income tax will be charged on income arising to the trustees of a 'settlement' with the definition of settlement being derived from existing trust law and case law, and 'settled property' being defined in the tax legislation. The trustees of a settlement will be treated as a single person for income tax and TCGA purposes.

Common Residence Test

15.18 A common test will provide consistency and clarity for trustees and advisers. The common residence test which is to be adopted for the purposes of both income tax and tax on chargeable gains, is to be modelled on the current income tax test, based initially on the residence status of the trustees, and using the residence and domicile status of the settlors as a tie-breaker where the body of trustees contains a mixture of UK resident and non-UK resident persons. The test will become effective from April 2007 in order to allow trustees the time to re-order their affairs in relation to their residence status.

15.19 We had also proposed to extend and modify the current professional trustee test, which applies for the purposes of chargeable gains and apply the modified test for purposes of both income tax and chargeable gains. However, we have been advised that this would constitute a State Aid, so this aspect of the Trust Modernisation proposals has been withdrawn.

Sub-fund Elections

15.20 Where assets of a single settlement have been split off into separate sub-funds administered on behalf of different beneficiaries, often by different bodies of trustees, the trustees of the settlement will be able to elect for the sub-funds to be treated as if they were separate settlements for income tax and TCGA purposes. This will reduce administrative burdens where separate sets of trustees within a single settlement are, at present, required to work together to prepare a single CGT computation.

15.21 This change provides for the making of an election to give rise to a disposal of the property comprising the sub-fund in question for the purposes of tax on chargeable gains, providing parity of treatment with trustees who use a power to settle property out of an existing settlement into a new settlement.

Harmonisation of Settlor Interest Tests

15.22 For TCGA purposes a settlement will be regarded as settlor-interested if a minor child (or step-child) of the settlor who is neither married nor in a civil partnership can or does benefit from the settlement during the tax year in question. This will bring the TCGA treatment more closely into line with the income tax treatment.

Retention of Character of Income

15.23 The income of all settlor-interested settlements will retain its character as it flows through the settlement, so that in the hands of a settlor it will be taxed at the same rates as it would had it arisen directly to him or her. This removes unhelpful anomalies in the rates of tax applying to settlors in such cases.

Single Charging Mechanism

15.24 A single charging mechanism will be introduced to ensure that capital items deemed to be income for tax purposes are brought into charge at the special trusts rates in a consistent way. Items that are capital in trust law but deemed to be income for tax purposes will be brought into charge as income of the trustees at the RAT or dividend trust rate as appropriate.

Beneficiaries of Settlor Interested Trusts

15.25 New legislation is being introduced to ensure that payments to beneficiaries of settlor-interested trusts will not be chargeable in the beneficiaries' hands.

Deferred Provisions

15.26 The following proposals had been suggested in previous consultation and discussion papers. However, we have encountered some difficulties in working out the detail of the proposals. They have therefore been deferred until a later date.

Allow Income to Stream through a Trust to a Beneficiary

15.27 The income streaming proposals are an important element of the Trust Modernisation package and were broadly welcomed in consultation, though some concerns were expressed about the potential of this proposal to increase the complexity of the tax system for trustees. We consider that the proposal is necessary to allow the full benefits of the changes made already to be delivered. However, we have encountered some difficulties in ensuring that income streaming works properly for all classes of trustees and need to explore further how the proposals will fit with existing legislation and practice. Further work will be taken forward with a view to introducing this measure at a later date.

Abolish the Tax Pool

15.28 This change would particularly benefit smaller trusts and enable them to realise fully the benefits of the new measures introduced in the Finance Act 2005. However, this proposal is inextricably linked to the income streaming proposal described above, and so work on this will be taken forward with the aim of introducing both measures at a later date.

Chargeable Gains of Estates

15.29 The proposal is that the personal representatives of a deceased person would be chargeable to CGT on gains arising from the estate at the rate of 20% up to a specified limit in the tax year of the deceased's death and the succeeding two tax years. This reduced rate of CGT would better reflect the personal circumstances of many beneficiaries who are lower or basic rate taxpayers and who would not normally pay CGT at the 40% rate. This measure is being deferred to a later date when it will form part of a wider package of measures to improve the tax treatment of estates.

Costs and Benefits

Sectors and Groups Affected

15.30 These measures will affect trustees of settlements and those advising or acting for trustees. This could include professional trustees, the legal profession, accountants, banks and lay trustees.

15.31 The Trust Modernisation package will reduce the burden of administration for settlements, especially benefiting lay trustees, by providing a more consistent approach to the taxation of income and gains arising in respect of settled property. What constitutes the "settlement" will be the same for income tax and TCGA purposes, and the residence status of the trustees of the settlement will be the same. The package should have an overall positive impact on those affected by the changes.

Benefits

15.32 The benefits of the changes being introduced will be:

- a reduction in the number of trusts within the SA regime;
- a more consistent approach to taxing trustees' income and gains;

- clearer tax rules relating to settlements; and
- a further reduction in the burdens on smaller settlements.

Costs

Policy Costs

15.33 There will be increased short-term costs for HMRC as a consequence of these changes. Staff will be made aware of the changes introduced and guidance, internal and external, will be produced and amended as appropriate. As well as the amendments needed to be made to the tax return for trustees, the tax return for individuals will need to be amended in order to cope with the changes in the definition of settlor-interested settlements.

Compliance Costs

15.34 The changes will not have a significant impact on trustees' compliance costs as most of the changes are designed to improve consistency in the way the tax system operates. Much of the definitional legislation will codify and clarify what already happens in practice.

15.35 In order to mitigate the risk that people may try to exploit the standard rate band by setting up several small settlements instead of one larger one, a new test will be introduced to ensure that a group of settlements established by the same settlor can benefit from only one standard rate band.

15.36 There may be a cost associated with trustees and advisers having to familiarise themselves with the changes.

Exchequer and Distributional Effects

15.37 Overall, there are negligible costs to the Exchequer arising from the changes being introduced as part of this Trust Modernisation package.

Other Impacts

Devolution

15.38 None at present. We are aware that there are differences between the underlying law relating to settlements in different parts of the UK, but most of the responses received in consultation have indicated the changes will work consistently throughout the UK.

Human Rights

15.39 There are no implications under the Human Rights Act.

Environmental

15.40 None.

Rural Proofing

15.41 None.

Small Business

15.42 We consider that the impact of the changes on small businesses will be minor and any impact that is felt is likely to be beneficial. Generally, trustees do not run small businesses and so small businesses will be unaffected by the measure. There may be an indirect effect on professional firms which happen to be small businesses in their own right.

15.43 The impact of the changes will be felt by trustees and settlors of settlements, which will include small settlements. From our data, there were around 170,000 small settlements in the tax year 2003/04 where we have defined a 'small settlement' as one having a tax bill of less than £1000 a year.

15.44 In particular, the trustees of smaller settlements will benefit from the increase in the limit of the standard rate band, and there should be a reduction in administrative burdens gained from the modernisation of the taxation of trusts. One example of this is the common residency test which will mean that those settlements with different residence status for income tax and CGT purposes will, in the future, have the same UK residence status for both taxes, reducing the burden of complying with the tax regime for settlements.

15.45 From our consultation and discussions with representative bodies, we feel that this view is held in common with trust professionals, though as indicated above some concerns have been expressed about particular aspects of the changes.

Competition Assessment

15.46 It seems reasonable to define the market affected by the Trust Modernisation package as limited to those firms, which offer services in the area of settlements. This includes professional trustees, some banks and legal and accountancy firms. These are likely to act for settlements in either an advisory or fiduciary manner, or both.

15.47 The 'settlements' market is a specialist field and not controlled by any dominant firm. The Trusts Modernisation package will modify aspects of the income tax and TCGA rules for all settlements and as such should not affect some firms more than others. Any increase in compliance costs for trustees as a result of the proposed change should be negligible, and indeed, the new system should reduce the administrative burden on many trustees, especially the trustees of smaller settlements, which have already benefited from the introduction of the standard rate band.

15.48 The changes will affect all the firms dealing with settlements in the same way and it is unlikely that the proposals will result in any changes to the market structure. New firms should not be affected disproportionately. The package will also prevent any tax avoidance schemes seeking to use capital receipts, which are taxed as income. To the extent that it affects professional trustees, we expect the impact, in terms of competition, to be minimal. The changes will not have any impact upon technological and product developments in the legal profession.

Enforcement, Sanctions and Monitoring

15.49 The provisions being introduced are intended to make it easier for lay trustees to comply with their obligations. Therefore, we think the danger of non-compliance is minimal. We will continue to monitor tax returns and review entries in the usual manner.

15.50 Trustees who receive a taxed income of £1000 a year or less will not usually be required to make a tax return, unless required to do so for CGT purposes or because they have additional income tax to pay. The measures being introduced do not increase the likelihood of non-compliance, and we already have systems in place to monitor and enforce compliance.

15.51 Our current system for monitoring compliance with the tax regime by trustees and other persons connected with trustees is based on selective examination of the Self Assessment returns filed by the trustees of settlements. The examination is based on the degree of risk of a loss of tax to the Exchequer. We believe that this approach will continue to be appropriate once the changes covered in this Regulatory Impact Analysis come into effect.

15.52 The changes will not impose additional burdens on any other government organisation.

Implementation and Delivery Plan

15.53 Most of the provisions in the Trust Modernisation package will come into effect from 6 April 2006 and we will be amending the return guide for future years as necessary. However, the common residence test will come into effect from 6 April 2007.

15.54 We are continuing work on trust modernisation and intend to introduce further measures at a later date. The deferred measures are as set out at paragraphs 24-26 of this full RIA.

15.55 We are preparing guidance of the changes for staff which will appear on the trusts pages of the HMRC website. We are also preparing guidance for taxpayers and practitioners.

15.56 Annex A contains a detailed implementation plan.

Post-implementation Review

15.57 We will conduct a review of the effectiveness of all the new Trust Modernisation legislation in September 2007 by which time most of the changes will have taken effect and be established as normal practice.

15.58 We will continue our discussions with trustees and other interested parties to ensure the changes are being implemented correctly.

Summary and Recommendation

- Many settlements will benefit from the reduction in administrative burdens.
- There may be a small cost to HMRC for issuing guidance and amending tax returns.
- The overall cost of the Trust Modernisation package is negligible.

15.59 The Trust Modernisation package has been discussed with representative bodies and other interested parties over a period of time, and the package will reduce burdens, particularly those on trustees of small settlements, and deliver consistency in the way income and gains arising under settlements are taxed.

15.60 We are continuing work on Trust Modernisation with a view to introducing further measures intending to benefit settlements in the future.

Annex A - Implementation and Delivery Plan

A.1 The proposals reduce the administrative burdens on the trustees of settlements. In the main they will not impose further obligations on them. Those proposals, which do make a requirement or where the charge to tax will be modified are noted below.

A.2 Guidance and training will be provided for staff on the new measures. We are also preparing guidance for taxpayers and practitioners, amending the existing guidance as necessary. Where appropriate, the Trust and Estate Return and the Return for individuals will be amended together with the accompanying guidance notes.

Sub-fund Elections

A.3 An election form will be introduced to enable trustees of settlements to elect for sub-funds to be treated for tax purposes as if they were separate settlements. The election form will require a declaration by each trustee of the principal settlement that he or she gives consent, a statement that the necessary conditions are satisfied and such other declarations as the Commissioners for HMRC may require, in particular details of the trustees, the trusts, the property comprised in the settlement, the settlors and beneficiaries.

A.4 Where such an election has been made HMRC may require a trustee, beneficiary or settlor of the principal and sub-fund settlements to provide information in order to determine whether the relevant conditions for the election are satisfied.

A.5 Where an election has been made the sub-fund settlement will be subject to the same requirements and obligations for tax purposes as other settlements. In most cases this will mean having to make an annual return of income and gains.

Retention of Character of Income

A.6 The tax return for individuals will be amended for 2006-2007 onwards and associated changes made to the IT systems that support this work. This will enable individuals who are settlors of settlor interested settlements to return income treated as arising to them so that the correct rates of tax are applied to the different types of income. The guidance notes accompanying the return will be amended to reflect these changes.

Single Charging Mechanism

A.7 The Trust and Estate return will be amended for 2006-2007 onwards and associated changes made to the IT systems that support this work. This will ensure that all capital items that are deemed to be income for tax purposes are charged at the special trusts rates. The guidance notes accompanying the return will be amended to reflect these changes.

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REGULATORY IMPACT ASSESSMENT

Trust Modernisation

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo
Paymaster General

Dated: 8 March 2006