STEP’s response to HMRC’s The Taxation of Trusts consultation document published on 7 November 2018

About us

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have over 20,000 members across 95 countries, with over 7,000 members in the UK. Our membership is drawn from a range of professions, including lawyers, accountants and other specialists. Our members help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.

We take a leading role in explaining our members’ views and expertise to governments, tax authorities, regulators and the public. We work with governments and regulatory authorities to examine the likely impact of any proposed changes, providing technical advice and support and responding to consultations.

STEP welcomes the opportunity to respond to this consultation.

Introduction

STEP is encouraged that the Government recognises that “trusts are an intrinsic part of the UK’s legal system” and that “there are many circumstances throughout UK society in which trusts play a valuable role”.

UK trusts and those outside the UK provide a framework for numerous objectives such as succession planning, asset protection, control of family businesses, pension provision, life assurance, protection of children and vulnerable family members and charitable giving.

Their valuable role is attested to by STEP’s 2018 survey of its 7,000 UK members. Respondents selected providing control and flexibility over the way money is distributed after death and to protect vulnerable family members as the two most popular reasons for setting up a trust. In a later question both reasons were identified as growth areas by respondents.

The Ipsos MORI research published alongside the consultation document supports these findings; identifying control, flexibility and protecting assets from occurrences such as divorce and poor decision making as key factors behind setting up a trust. Citing more specific examples the Money Advice Service notes that trusts can be used by individuals
wanting to ensure vulnerable beneficiaries are provided for after they pass away or to help people with learning difficulties receive benefits payments.

There is no doubt that trusts play a valuable role in society. However, there is also no doubt that due to the inheritance tax ("IHT") charge that applies on the creation of a lifetime trust, UK individuals are discouraged from establishing trusts or, also highlighted in the Ipsos MORI research, limit any lifetime gifts into trust to the amount of the IHT Nil Rate Band.

This has damaged the UK’s domestic trust industry and, as a consequence, has eroded the UK’s reputation as a centre of excellence for trust related advice and services in the international context.

STEP fully supports the Government’s desire to make the taxation of trusts, simpler, fairer and more transparent while recognising that in some ways these are rather incompatible goals and the consultation must be realistic in what it can achieve.

1) The Government seeks views on whether the principles of transparency, fairness and neutrality, and simplicity constitute a reasonable approach to ensure an effective trust taxation system; including views on how to balance fairness with simplicity where the two principles could lead to different outcomes.

STEP welcomes the review of the taxation of trusts which provides an opportunity to address certain needless complexities in the system and a chance to propose some changes which will help practitioners, their clients and the Government.

Simplifying the tax regime around trusts is very desirable and is an outcome that STEP would welcome. Removal of some of the complexities will ensure that the many people who use trusts will benefit. STEP would endorse a ‘clear and transparent regime that is easy to understand’ as stated in the consultation.

The starting point is that the tax generated from the use of a trust should be largely neutral when compared to the tax that would be generated by an individual or group of individuals who own the assets outright. Neutrality in this way will lead to a fairer, more consistent and less discriminatory system between different taxpayers. The difficulty is that neutrality can often be difficult to measure as each individual will have different economic circumstances.

We support the Government’s measures for transparency provided that families can maintain their basic rights to legitimate confidentiality and privacy from the general public in relation to their financial affairs. Importantly a large number of trusts are created to
protect the interests of vulnerable family members who will be at high risk of abuse of information if their financial status is widely available to the public.

We believe that there are a number of options that the Government could take that would achieve such objectives and have outlined these in the following paper.

2. There is already significant activity under way in relation to trust transparency. However, Government seeks views and evidence on whether there are other measures it could take to enhance transparency still further.

The raft of transparency initiatives that affect private clients in relation to the existing and proposed registers of beneficial ownership for UK companies, trusts and UK real estate has been extensive in recent years.

In particular, the focus on the disclosure of beneficial ownership information has been sustained with far reaching consequences. It has been well documented by the Financial Action Task Force (FATF) on many occasions that trusts are seen as a low risk vehicle for money-laundering. Involving third party professionals who are regulated and have specific anti-money laundering obligations is unlikely to be attractive to those with criminal intent. Those with criminal intentions would be inclined to use legal entities that they can more easily control that are not subjected to the same degree of third party scrutiny.

The Government reiterated this view earlier this year when it announced that the beneficial ownership register of foreign companies that own or buy UK property will go live in early 2021. All companies must provide their beneficial ownership information to their legal representatives during a property or land purchase, as part of the due diligence process. However, trusts have been excluded from disclosure on this register and the Government explains why they are exempt in its consultation:

“Several responses suggested that trusts should also be included. Unlike companies, trusts are typically used by private individuals for managing family owned assets including for minors and vulnerable family members. HMRC have recently set up the Trust Registration Service and the data is shared with law enforcement which should allow them to identify who owns and benefits from trusts. Publishing these persons details would not be proportionate and effective especially as disclosure would undermine family confidentiality.” The Government emphasises that the risk of money laundering in the context of trusts is very low and that the adverse risk to vulnerable individuals is disproportionate.

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1 A register of beneficial owners of overseas companies and other legal entities, UK Government, 22 March 2018

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However, trusts have been incorporated into the majority of transparency initiatives in recent years. The introduction of the Common Reporting Standard (CRS) followed a mass of governmental efforts, such as the US Foreign Account Tax Compliance Act and Council Directive 2003/48/EC (known as the EU Savings Directive), to improve cross-border tax compliance. The CRS is a way for countries to automatically exchange information about non-residents holding bank accounts and other financial accounts offshore. By September 2018 over 100 jurisdictions had made annual exchanges of information.

In addition the EU Directive on Administrative Cooperation in the Field of Taxation (DAC6) which came into effect in May 2018 requires the automatic exchange of information in relation to certain cross border arrangements.

In 2017, Part 5 of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations imposed obligations on trustees of both existing and new taxable “relevant trusts” to maintain accurate and up-to-date written records of all beneficial owners.

In addition to the recent implementation of 4AMLD, 5AMLD was implemented in June 2018. The 5AMLD requirements for registration apply not only to trusts with UK tax consequences (4AMLD), but also UK express trusts as well as certain trusts that own UK real estate (residential or commercial property) or have a “business relationship” in the UK.

There will also be expanded access to the 5AMLD trust register and each of the Member States will use its own discretion over who has access to the information contained within the register. Serious concerns have been raised about the data protection and privacy implications of having a widely accessible or centralised public register.

Given these initiatives, STEP does not believe that further transparency measures relating to trusts are either necessary or appropriate.

3. The benefits and disadvantages of the UK’s current approach to defining the territorial scope of trusts and on any other potential options

Generally speaking, the rules governing the residence of trusts are relatively simple and well understood.

There is however one major exception to this which is that a non-UK trustee is treated as being UK resident if that person acts as a trustee in the course of a business which is
carried on in the UK through a branch, agency or permanent establishment in the UK (see s 475(6) ITA 2007 and s 69(2D) TCGA 1992).

In our experience, these provisions are not well understood by trustees/settlers, professional advisers or HMRC. Although detailed guidance was produced as a result of discussions between HMRC and STEP/CIOT/ICAEW, there is still significant uncertainty as to the circumstances in which a trustee may be treated as carrying on business in the UK through a branch, agency or permanent establishment. We have also never seen these provisions invoked by HMRC.

We do therefore question the need to complicate what is otherwise a simple test. It would provide much more certainty if the test were based purely on the tax residence of the trustees and the residence/domicile of the settlor.

Unless there is a policy objection to UK resident individuals establishing non-UK tax resident trusts, we do not see any problem with the fact that it is relatively straightforward for a UK resident individual to do so. Indeed, the fact that there is a clear test to establish whether the trust is UK tax resident or not is a good feature of the tax system.

There is one further point which we believe the Government should consider which is whether it should be possible for foreign individuals to establish a non-UK resident trust which only has UK trustees and which is administered in the UK. This was the case for CGT purposes until 5 April 2007 as long as the UK trustees were professional trustees.

As noted in the consultation document, a trust which is established by a non-UK resident/domiciled settlor will still be UK tax resident if it only has UK trustees even if there are no UK beneficiaries.

In our view, this is a missed opportunity for the UK as it results in non-UK resident and/or domiciled settlors, who might very well wish to take advantage of the range of expertise available in the UK, giving their business to other jurisdictions. This is not only something which would benefit trust professionals but also others such as lawyers, accountants, banks and investment managers.

Enabling foreign settlors to set up trusts in the UK which are not treated as UK tax resident provided one or more of the trustees is a professional would create additional business opportunities for all of these service providers and would therefore create jobs in the UK. It would also result in additional tax revenues for the UK based on the profits of the businesses concerned and the salaries of their employees.
This approach is one which has been taken by a number of other jurisdictions including the US, Switzerland, New Zealand and Israel. Malta and Cyprus also allow resident trustees where the trust income/gains are exempt from local tax. In a civil law context, it is possible to set up a private family foundation in the Netherlands which is not subject to Dutch tax.

In addition, allowing non-UK settlors to establish trusts in the UK which are not UK tax resident would have benefits as far as transparency is concerned. Such trusts would be required to be registered on the UK trusts register following the amendments required by 5AMLD (as the trusts would be administered in the UK) even though no UK tax will be payable. It is acknowledged in the latest national risk assessment that UK trusts do not pose a significant risk of money laundering or terrorist financing.

As a matter of practice, establishing a trust in the UK which is not UK tax resident is something which some non-UK resident individuals already do. However, in order to avoid the trust being UK tax resident, it is necessary to have at least one non-UK resident trustee. This causes unnecessary complexity.

What we would propose instead is a test which would work as follows:

(a) If the settlor is resident and domiciled in the UK, the trust will be UK tax resident unless all of the trustees are non-UK resident.

(b) If the settlor is either resident or domiciled outside the UK, the trust will be UK tax resident if all of the trustees are UK resident unless a majority of the UK resident trustees are professional trustees (in which case the trust will be non-UK tax resident).

The requirement for there to be a professional trustee if a trust which only has UK trustees is to be treated as non-UK tax resident is to ensure that the trust is administered properly and complies with any tax and transparency obligations.

A more radical (but simpler) alternative would be for the default position to be that a trust which only has UK trustees would be UK tax resident but to give the trustees of a settlement established by a settlor who is either resident or domiciled outside the UK the right to elect that the trustees should be treated as non-UK tax resident if at least one of the trustees is a professional trustee.

This would allow a foreign settlor (for example, one who is resident but not domiciled in the UK) to establish a UK tax resident trust which only has UK professional trustees which would not be possible on the basis of the test outlined above.
4. The Government seeks views and evidence on the reasons a UK resident and/or domiciled person might have for choosing to use a non-resident trust rather than a UK resident trust?

Trusts are widely used internationally for succession planning, to maintain control of family businesses, and to ensure capital is not dissipated by improvident or unwise beneficiaries.

In the present era of increasing individual mobility, many international trusts have beneficiaries resident in multiple jurisdictions, and beneficiaries often migrate from one jurisdiction to another. What those creating such a trust require is trustees resident in a tax neutral jurisdiction, i.e. a jurisdiction which does not itself tax the trust, but recognises tax is a matter for the jurisdictions where the assets are situate and those where the settlor and beneficiaries are resident.

The principal jurisdictions where international trusts are formed and resident are British Overseas Territories and Crown Dependencies and former British colonies. The reason why this is so is that trusts are creatures of the common law and are part of the heritage of current and former British Territories. As is well recognised, fiduciary businesses in these territories make significant use of UK professional and asset management services and are thus a significant indirect contributor to the UK economy. They are also well regulated, CRS reporting ensures transparency and, in part as a result of the initiatives outlined in the consultative document, tax evasion is not tolerated.

The widespread attraction of international trusts means that trusts with a substantial UK connection are a relatively small part of the overall population of international trusts. That said, increasing individual mobility means that international trusts often have one or more beneficiaries who are UK resident.

Most non-UK resident trusts settled by UK residents form part of the continuum of international trusts, in that the settlor is non-UK domiciled and thus by definition often himself internationally mobile and with family members resident in multiple jurisdictions. In general these trusts are formed for the reasons referred to above, namely succession, control of family business, and asset protection. They are not resident in the UK as this would expose the trust’s non-UK investments to income tax and CGT, and so breach the requirement of tax neutrality referred to above.

At one time, non-resident trusts were an effective tax planning vehicle for UK domiciliaries, principally in the years 1981 to 1998. Now, however, the successive reforms referred to in the consultation document have largely removed the tax advantages they previously enjoyed. In summary the tax position is as follows:
(1) For IHT purposes, a non-UK trust has no advantage over a UK trust as tax exposure turns on the domicile of the settlor rather than the residence of the trust.

(2) There is a slight income tax advantage in using a non-UK trust, in that the non-UK income of a non-resident trust is not taxed as it arises provided the settlor and his spouse are completely excluded from actual or possible benefit.

(3) There is little CGT advantage in that trust gains of a non-UK trust are taxed on the settlor unless he is dead or all his close family are excluded as beneficiaries.

(4) Even where trust income and gains are not taxed as they arise, distributions and benefits provided to UK residents are subject to income tax and/or CGT by reference to the trust income and gains.

In practice, since 1998 very few UK resident and domiciled individuals have settled non-UK resident trusts. Indeed, in reality, the traffic has been in the opposite direction in that many offshore trusts formed by UK resident and domiciled settlors in the period 1981 to 1998 have been brought onshore or terminated by distribution.

5. The Government seeks views and evidence on any current uses of non resident trusts for avoidance and evasion, and on the options for measures to address this in future

As indicated in the response to the previous question, STEP does not consider non-resident trusts are able to be used for evasion and their scope for avoidance contrary to government policy has been largely curtailed. In STEP’s view a much bigger problem now is that the legislation targeting offshore trusts has grown up in a piecemeal fashion and is frequently uncertain in meaning and counter intuitive in impact.

The recent Requirement to Correct process has brought to light significant unintended non-compliance. Some of this is the result of poor advice, but much is the consequence of the legislation being so dense and obscure that even some professionals fail to grasp its ambit. A particular problem is legislation targeted at one particular form of avoidance, often unrelated to offshore trusts, potentially having wide unintended consequences which may affect trusts.

In STEP’s view unintended non-compliance may well, in the future, come to be a much bigger issue than artificial and intentional avoidance. For example, due to the complexity of the rules and the interaction with other anti-avoidance rules e.g. the definition of close company, the application of the IHT rules for non-resident discretionary trusts owning residential property as an investment through investment funds is likely to give rise to unintended non-compliance by offshore trustees.
6. Reform to the IHT regime as it applies to trust

The way in which trusts are treated for IHT purposes is a significant area of complexity where there is definite scope for simplification.

The disincentive for UK domiciliaries to set up lifetime trusts i.e. the 20% entry charge means that the existing regime does not pass the test of fairness/neutrality (see paragraph 5.1 of the consultation paper) even though it could be argued (as put forward in paragraph 5.5.2 of the consultation paper) that the total IHT charges under the relevant property regime might not exceed the IHT payable on an individual’s death.

We would in any event argue strongly that this is a misleading comparison. The most straightforward way of achieving fairness and neutrality is to have a regime which allows an individual to make a gift to a trust on exactly the same basis as that person could have made a gift to another individual as long as the trust assets are treated for IHT purposes as forming part of the estate of another individual.

This of course means that a gift to a trust in these circumstances would qualify as a potentially exempt transfer (“PET”) but that, on the other hand, there would be a charge to IHT on the death of the relevant beneficiary. We expand on this in more detail below.

There are a number of different categories of trust for IHT purposes:

**Relevant property trusts**

Most trusts which can currently be created during an individual’s lifetime will be “relevant property” trusts. These are trusts where the assets are not treated as part of the estate of any individual. Instead, there are IHT charges when the settlement is created then every ten years and also when assets are distributed out of the trust.

The main problem with this regime is that the mechanism for calculating the IHT is incredibly complicated and time consuming, both for the taxpayer and for HMRC. It is almost impossible for any taxpayer to get it right without professional help. Significant amounts of historic information are required which is often not easy to obtain. The amounts of tax due are often relatively small (in many cases hundreds, rather than thousands of pounds) and it is not at all uncommon for the cost of completing the required IHT returns to exceed the amount of tax due.

There is also one perceived area of unfairness which is that assets in a trust where the settlor is also a beneficiary are not only subject to the relevant property regime but are also deemed to be part of the settlor’s estate (under the reservation of benefit (ROB) rules) and therefore subject to an IHT charge on the settlor’s death.
Interest in possession ("IIP") trusts

There are currently only four categories of qualifying interest in possession trusts.

- Trusts set up before 22 March 2006 where an individual has an interest in possession (broadly speaking the right to the income from the trust property).

- Immediate post-death interests – this is where a trust is set up on death and an individual has an interest in possession in that trust.

- Transitional serial interests – there is now only be created where there was a pre-2006 IIP trust and the spouse or civil partner of the person entitled to the IIP themselves becomes entitled to an IIP on that person’s death.

- Disabled trusts

The great benefit of the qualifying IIP regime is that it is very straightforward. The assets of the trust are simply treated as part of the estate of the beneficiary who is entitled to the IIP and are taxed on that person’s death. This is much simpler than the relevant property regime.

However, it is not possible for an individual to establish a qualifying IIP trust during their lifetime other than for a disabled beneficiary.

Any other lifetime trust is, as mentioned above, a relevant property trust and will suffer the 20% entry charge. There is therefore a clear anomaly between lifetime trusts where generally a qualifying IIP cannot be established and trusts established on death where one can be established.

This can also lead to avoidance as IIP beneficiaries within a relevant property trust can be changed for income tax reasons without any IHT consequences. This would not be possible if all trusts where an individual took a right to the income were treated as qualifying IIPs for s49 IHTA 1984 purposes. Ending the IIP would then have IHT consequences.

At best the current regime for lifetime trusts creates more complexity given that the relevant property regime is much more complicated than the qualifying IIP regime. At worst, it distorts behaviour in that it inhibits individuals from setting up trusts in circumstances where they might otherwise wish to do so for the perfectly good, non-tax reasons which the Government recognises in the consultation paper.
There is no doubt that many individuals make gifts during their lifetime (whether outright or to a trust) partly because they want to benefit the donee but also because they know that if the gift is made on death, IHT will be payable. However, Government policy is to permit (or arguably even encourage) lifetime gifts to individuals given the PET regime. There seems no good reason in principle why there should be a difference between a gift to an individual as opposed to a gift to a trust.

The complexity of the relevant property regime is an issue which applies both to individuals of moderate wealth (who might consider setting up a trust containing assets below the value of the IHT Nil Rate Band) and also to more wealthy individuals.

Due to the 20% entry charge for relevant property trusts in excess of the Nil Rate Band mentioned above, individuals have instead turned to alternative estate planning vehicles such as family investment companies. Although a family investment company can be structured so that voting control and economic benefits are split (thus allowing the donor to retain some measure of control), these sorts of vehicles have a number of problems when compared with trusts including, potentially, loss of tax to the Exchequer.

In our experience, most clients would much prefer to use a trust for their estate planning needs than a company given the non-tax advantages offered by a trust.

Allowing lifetime qualifying IIP trusts to be created therefore has a number of advantages as well as giving individuals more choice when considering their estate planning needs:

- Many more trusts will be created which are within the simpler qualifying IIP regime rather than the more complicated relevant property regime.
- Individuals will not be forced into using vehicles which were not really designed for estate planning purposes such as family investment companies.

**Trusts for children**

There are two special IHT regimes which apply to trusts for children:

- Trusts for bereaved minors;
- Age 18 to 25 trusts.

The main difference between the two regimes is that there is an IHT charge (rather like the relevant property regime exit charge) when the beneficiary becomes entitled to the trust assets assuming this happens after the beneficiary is 18.
In our view, these provisions would no longer be required if our package of proposals set out below is adopted. This would lead to significant simplification and reduce avoidance.

**STEP’s package of proposals for reform**

It would be possible for the tax regime applying to trusts to be made simpler and arguably fairer (as well as removing opportunities for avoidance).

In 2017/18 £21m IHT was raised by lifetime transfers (mainly comprising the entry charge or other chargeable transfers involving close companies). This was an increase of £3m from £18m in 2016/17. IHT receipts from the relevant property regime were £180m in 2017/18 which seems to be a high point in terms of yield apart from 2015/16 when it was £187m.

By contrast the total yield on death transfers was just over £5bn and therefore the tax raised under the current relevant property regime on entry charges and 10 year/exit charges combined is less than 4% of the total IHT raised. In short, the IHT yield from trusts does not appear to have been more than 5% in any year. The level of complexity which currently exists does not seem justified by the very low yield.

Given that it might reasonably be assumed that the time spent by both advisers and HMRC staff in dealing with trusts is considerably more than 3% or 4% of the total time spent dealing with IHT matters, it seems timely to consider an alternative framework in line with the remit of the trust consultation. We have therefore put forward a package of measures set out below.

1. **Full transparency for settlor interested trusts**

1.1 It should be possible for an UK resident individual (wherever domiciled) to create (during lifetime) a settlor interested UK trust (whether discretionary or an IIP) which would be a look through for all tax purposes. By this, we mean that the settlor would be treated as the owner of the assets held in the trust. This would be a regime similar to that of the US grantor trust and it should be noted that other jurisdictions such as Switzerland, Italy and Germany also treat trusts and foundations as transparent to the settlor where he has significant influence/is a beneficiary. Therefore, this approach would be consistent with the way other jurisdictions tax these vehicles (thus avoiding double taxation) and would also limit avoidance by reducing arbitrage between jurisdictions.

1.2 There are currently differences in the definitions of a settlor interested trust for income tax and CGT hold over relief purposes. In addition, IHT does not have the
concept of a settlor interested trust but “reservation of benefit” which in some cases applies only to settlors and in other cases applies to settlors and spouses/civil partners.\(^2\)

1.3 We suggest that a trust should be settlor interested for the purposes of the transparency regime if the settlor or the settlor’s spouse or civil partner can or could benefit. Any possibility of benefit by a minor child of the settlor or other family member should not result in the trust being settlor interested (although the income tax settlements code would still need to ensure that income distributed to minor children is taxed at the rate applicable to any living settlor).

1.4 The proposed rules would apply to settlements in the strict sense (i.e. trusts) not in the wider sense given to the term by s620 ITTOIA 2005. Further consideration would need to be given to the tax treatment of arrangements that are not settlements in the strict sense such as bare trusts.

1.5 A settlor may wish to use such a trust to enable an independent trustee to manage his financial affairs which may avoid the need for a lasting power of attorney (property and financial affairs). Trustees generally have more wide ranging powers than an attorney. It would also be useful to ensure continuity for the settlor’s surviving spouse or civil partner or other family members on the settlor’s death as probate would not be required in relation to those assets eg family businesses, farms etc. Having a simple form of settlor interested transparent trust where the trustees have little or no ongoing tax compliance would make trusts a viable solution even where the trust assets are of relatively low value.

1.6 IHT
(a) The assets of the trust would be treated as remaining in the estate of the settlor and so there would be no transfer of value when the assets are settled. The transfer is simply a non-event for all tax purposes including IHT. No reporting would be required.

(b) During the lifetime of the settlor there would be no IHT charges as the trust would not be within the relevant property regime. This would be irrespective of whether the trust is discretionary or an IIP.

(c) On the death of the settlor, the trust assets would be chargeable in the estate of the settlor in the same way as assets owned personally and with the benefit of the same exemptions (eg the s18 IHTA 1984 exemption if a spouse or civil partner has a subsequent IIP interest).

\(^2\) E.g. land and certain insurance bonds
(d) After the settlor’s death, the IHT treatment of the trust assets would depend on the nature of the trust and would be treated as if they had been settled on the date of the settlor’s death. So if the subsequent beneficiaries (e.g., children or spouse/civil partner) take an IIP, then this would be a qualifying IIP for IHT purposes (see section 2 below), otherwise it would enter the relevant property regime.

(e) If the settlor’s interest is terminated during the settlor’s lifetime (e.g., the settlor and spouse/civil partner are excluded from benefit), this would be a disposal for CGT purposes and a transfer of value for IHT purposes (chargeable as a PET or an immediately chargeable transfer depending on the nature of any ongoing trusts or if the assets pass outright to a beneficiary).

1.7 Income tax

(a) The settlor would report and be taxable on the income of the trust at his marginal tax rates and with the benefit of his personal allowances. This would be irrespective of whether income is distributed.

(b) No deduction for trust management expenses would be allowed.

(c) The trustees would not be subject to income tax on trust income whether or not it is distributed.

(d) Other beneficiaries receiving income distributions would not be taxable on the income received and it would not be counted as their income for any other purpose (e.g., restriction of personal allowances).

(e) As the settlor would be taxable on all trust income as it arises whether or not he actually receives it, there would be no need for the current rules regarding capital sums and loans. In any event the capital sums provisions in s633 ITTOIA 2005 achieve nothing but extraordinary and completely unnecessary complexity given that trust rates can sometimes be higher than settlor tax rates and our experience is that the compliance aspects of these provisions are poorly understood by HMRC. Abolition of these provisions would greatly simplify the code at no revenue cost at all.

(f) After the settlor’s death the income treatment would depend on the nature of the ongoing trusts (if any). If the settlor’s spouse/civil partner or child/other beneficiary takes an IIP, then that person would be taxed on the income. It would not seem appropriate to tax the settlor’s spouse or civil partner on all income (and gains) arising in the same way as the settlor as it may be difficult to enforce rights of reimbursement from.
trustees particularly in the case of second marriages. Unlike the settlor, the spouse and other beneficiaries have not had a choice as to whether to set up a trust of this nature. It would therefore seem harsh to tax them on all income and gains whether or not received. Instead they should pay tax only on the income received.

1.8 CGT

(a) There would be no CGT disposal when assets are settled as they remain taxable in the settlor's hands. Therefore the whole question of hold over relief on settling assets would therefore disappear.

(b) All trust gains would be reportable by and taxable on the settlor at his CGT rates with the benefit of his annual exemption.

(c) The trustees would not be taxable on the gains during the settlor's lifetime.

(d) Entrepreneurs' relief etc would be applied on the basis that the settlor still owned the assets for CGT purposes so any voting rights of trustees would be attributable to him.

(e) In line with full transparency, personal losses of the settlor should be capable of set off against trust gains and trust losses should be capable of set off against personal gains when calculating the tax charge on the settlor with any reimbursement being made between the trustees and the settlor.

(f) On the settlor's death the trust assets would benefit from a CGT free uplift as if he still owned the assets outright.

(g) If the settlor's interest came to an end during the settlor's lifetime (ie the settlor and spouse/civil partner are excluded from benefit), this would be a disposal for CGT purposes and hold over relief would be available only if the disposal would qualify under the current rules.

(h) After the settlor's death (or the termination of the settlor's interest), if there are ongoing trusts, the tax treatment will depend on the nature of the trusts. After the settlor's death if the spouse/civil partner takes an interest in the trust it does not seem appropriate at that stage to charge all the trust gains on the survivor; unlike the settlor the surviving spouse/civil partner has not had a choice as to whether or not to set up the trust and it may be difficult to enforce reimbursement from the trustees in some families.

1.9 Other points
(a) If the settlor is a remittance basis user then the remittance basis should apply to the income and gains on which he is taxable as if they were his own (so foreign source income would be taxable on the remittance basis).

(b) The trustees would file an annual return giving only the settlor's details and UTR and the settlor's return would give the trustees' details and report all the trust income and gains.

(c) The trustees would be obliged to provide the settlor with full details of the income and gains generated in the trust each year and the settlor would be taxed on such gains and income whether or not he received them.

(d) The settlor would be entitled to reimbursement from the trustees for the tax paid by him in relation to trust income/gains not distributed to him.

(e) Existing settlor interested trusts would continue to be taxed under the current regime unless the settlor/trustees elect to move to the new regime.

(f) Our proposal for a transparent settlor interested trust is made on the basis that this would apply to UK resident trusts. However, logically we can see no reason why, in principle, the same treatment could not also apply to non-UK resident trusts. The current tax treatment of non-UK resident trusts is not only extremely complex but also gives rise to inconsistencies and unfairness. We would be happy to discuss this issue and to prepare a more detailed paper in relation to how the taxation of non-resident settlor interested trusts could be simplified and made more coherent, if this is something that the Government wishes to consider.

2. **IHT transparency for IIP trusts (which are not settlor interested)**

2.1 All IIPs should be “qualifying” for IHT purposes even if property is settled during the settlor’s lifetime. The current distinction between an IPDI which can only be created on death and which is a qualifying IIP trust and an IIP trust set up during the settlor's lifetime which is not a qualifying IIP does not seem justifiable in policy terms. That being the case and given that the IHT arising under the relevant property regime is not substantial, we can see no reason for not allowing IIPs created during lifetime to be qualifying IIPs.

2.2 This type of trust would be useful where it is wished to provide for children (including minor or adult children) or grandchildren, particularly those who are in need of some protection but who do not qualify under existing regimes for disabled person's interests/vulnerable beneficiaries.
2.3 Lifetime gifts to trusts which can benefit the settlor's spouse/civil partner would be taxed as if the property still belonged to the settlor for all tax purposes (see section 1 above).

2.4 IHT

(a) A gift to a lifetime qualifying IIP trust would be a PET for IHT purposes.

(b) There would be no IHT charges during the currency of the IIP.

(c) If the IIP is terminated during the lifetime of the life tenant that would be a PET (if another beneficiary took outright or on IIP trusts) or a chargeable lifetime transfer (if discretionary trusts arose), by the life tenant. The original life tenant would have to be wholly excluded as at present to avoid ROB issues.

(d) On the life tenant's IHT would be levied on the same basis as if the life tenant owned the trust assets outright with the possibility of the s18 IHTA 1984 spouse/civil partner exemption if the assets then passed on IIP trusts for or outright to the life tenant's spouse/civil partner. The nature of the IHT regime after the death of the life tenant death would depend on whether the ongoing trusts were discretionary or IIP.

(e) The relevant property trust regime would apply to non-IIP trusts which are not settlor interested trusts.

(f) If a discretionary trust becomes an IIP later, it would leave the relevant property regime and an exit charge would be imposed at that point.

(g) Existing non-qualifying IIP trusts would be taxed as at present for IHT purposes but could enter the qualifying IIP regime by appointing a new IIP for the same or another beneficiary with a corresponding relevant property charge.

2.5 Income tax

(a) There would be no change to the current taxation of income for the life tenant. The trustees would account for basic rate tax and then the balance after expenses would be distributed and taxed on the beneficiary with a credit for the basic rate tax paid.

(b) If the life tenant is the minor child of the settlor or the settlor's spouse/civil partner, the settlor should be taxable on that income whilst the child is a minor

2.6 CGT
(a) A transfer of assets to an IIP trust (of which the life tenant is anyone other than the settlor or the settlor's spouse/civil partner), would be treated as a disposal for CGT purposes.

(b) Gains realised by the trustees on trust assets would be taxable in the hands of the trustees at the trustees’ rates.

(c) On the death of the life tenant there would be a CGT uplift (as at that stage the assets would be subject to IHT in the estate of the life tenant).

3. Changes to the relevant property regime which would apply to discretionary non-settlor interested trusts

3.1 The IHT relevant property regime would continue to apply to discretionary trusts which are not settlor interested. However, as we have mentioned above the complexity of the rules for the calculation of 10 year anniversary and exit charges is such that the professional costs of calculating the charge may be greater than the amount of the tax due.

3.2 Whilst the idea of being able to set up a lifetime discretionary settlement without this being a chargeable lifetime transfer and then IHT at a fixed rate being levied on an annual basis throughout the life of the trust has some attractions, on balance we feel that this would be likely to penalise smaller trusts and the use of trusts to hold illiquid assets (such as insurance policies, farming land and other businesses) as they would need to finance the IHT charge on an annual basis and make an annual return.

3.3 We therefore feel that it would be preferable to simplify the way in which the relevant property regime charges are calculated as follows:

(a) On 10 yearly charges, a flat rate of 6% would apply on the value of the trust above the basic IHT threshold (£325,000).

(b) To prevent settlors taking advantage by the creation of multiple trusts, that threshold would be divided among all the relevant property trusts created by any individual settlor after the date the new rules come into effect and which are in existence at the date of the calculation; (we have in mind a system similar to that for the reduced CGT annual allowance for trustees). This would not affect the entry charge where a nil rate band would still be allowed every 7 years in respect of discretionary trusts.
(c) On exit charges, a rate of n/40ths of the flat rate of 6% would apply, according to the expired quarters since the last 10 year anniversary date (or since creation of the trust). This could be simplified still further to x/10ths according to the expired years. The tax would be charged on the amount by which the value of the trust assets before the relevant event exceeds the relevant threshold or, if less, the amount of the distribution (or reduction in value).

(d) All the other rules aggregating the history of lifetime transfers and other assets settled on the same day would be removed so saving the need to delve back into historical records. Some consideration would need to be given to s80 IHTA.

(e) It would be necessary, for fairness, to keep the rules making a proportionate reduction where assets have not been relevant property throughout the last 10 years, or throughout the period since the last 10 year anniversary.

3.4 Transitional provisions for existing trusts would need to be considered.

4. Trusts for minor children/grandchildren

4.1 There are many non-tax reasons why parents and grandparents wish to provide through a trust for young children or grandchildren rather than making outright gifts. 18 is generally regarded as too young to become entitled to significant amounts of capital. As noted above, people are forced into alternative rather artificial arrangements to avoid the entry charge.

4.2 If during lifetime (and on death) the settlor has the option of creating an IIP (taxed as set out above) or a discretionary trust for a child, then we do not consider that there is any real need to add complexity by having a separate regime which applies to trusts for minor children/grandchildren.

5. Trust for disabled persons

5.1 The existing complexities of the rules for disabled person interests for IHT and the vulnerable beneficiary rules for income tax and CGT make these regimes unattractive. We can go into the various complexities and anomalies in more detail if required. 3 By way of example only, the capital disregards in respect of a disabled person’s interest which is an actual IIP for a disabled beneficiary as opposed to a deemed IIP (i.e. an IIP falling

3 FA 2005 introduced special income tax and CGT treatment for qualifying trusts for vulnerable beneficiaries (disabled persons and bereaved minors), the effect of which was backdated to April 6, 2004. However, the complexity of the legislation and the limited nature of these reliefs make their value questionable.
5.2 The aim of the special income tax treatment\(^5\) is to ensure that the amount of tax charged on income accruing to the trustees is no more than it would have been had the income belonged to the vulnerable person. This apparently simple objective is obscured by some impenetrable drafting. A much easier option would be to treat the trust as transparent for income tax purposes so that all income was taxed as the beneficiary’s income whether or not he received it. The complicated pooling provisions for trusts would not apply.

5.3 We suggest that trusts for disabled persons should be taxed as for settlor interested trusts (see above) whether IIP or discretionary\(^6\) i.e. there would be complete transparency for all tax purposes so that the property is treated as that of the disabled beneficiary for tax purposes.

5.4 Payments to or for the disabled beneficiary’s benefit would be ignored for tax purposes as the gains and income would already have been taxed on that beneficiary.

5.5 On the disabled beneficiary’s death there would be a CGT uplift as if the assets were owned personally and IHT payable.

5.6 There would be no ability to benefit anyone other than the disabled beneficiary while alive except to the extent that this payment benefits the disabled beneficiary (and of course such a payment would not be a PET).\(^7\)

5.7 There would be one difference from settlor interested trusts in that the trustees would be responsible for accounting for the tax on income and gains (as these income and gains would not necessarily be distributed to the beneficiary) and paying the tax out of the trust assets. The trustees would be responsible for submitting one return based on the beneficiary’s total income and gains. Although it could be argued that it would be onerous for trustees to have to know about a disabled beneficiary’s other income and personal gains, we would argue that the current pooling arrangements and calculations

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\(^4\) FA 2013 Sch 44 para 10(5).

\(^5\) And CGT: see FA 2005 ss.26–32.

\(^6\) Generally disabled trusts are discretionary to avoid losing means tested benefits although reform could also be made in this area.

\(^7\) In relation to new trusts, during the life of the disabled person that individual alone must be capable of benefitting from the trust income or capital. Notice that this does not mean that he/she has to have an entitlement to benefit: it suffices that the trustees can pay him/her income in their discretion and advance capital to or for his/her benefit. It follows that, in general, no other person should be capable of benefitting during this period although a provision was introduced allowing small payments to be made each year that are not for the benefit of the disabled person.
are far more onerous and, in practice, limiting this tax regime to disabled beneficiaries rather than applying it to the children under 25 would target the correct people.

5.8 In most cases disabled beneficiaries will not have significant income from other sources and if they do the trustees will know about it as they will need to be informed generally of the beneficiary’s financial circumstances in order to work out whether and how much to distribute in any one year. In short, trustees of disabled beneficiaries are necessarily much more closely involved in the financial day to day circumstances of disabled beneficiaries than they are with most discretionary beneficiaries. Therefore, they can submit tax returns on behalf of that beneficiary showing the total income and gains including trust income and gains.

5.9 Existing disabled trusts would be taxed under current rules although if their terms were amended to comply with the new rules (e.g. so that no beneficiary other than the disabled person could benefit while he or she was alive) then they could elect into the new transparent regime.

5.10 Simple precedent forms would be made available online for disabled families to use in the same way as when registering charities. Australia has a regime similar to this which applies if there is a professional trustee. It could be provided that disabled trusts above a certain value must have a professional trustee or a trustee qualified in administering trusts for disabled beneficiaries (even if not a fully fledged lawyer or accountant) not least to protect the vulnerable beneficiaries. By decoupling disabled trusts from “children’s” or vulnerable beneficiary trusts one can more easily have a tax regime tailored to which is appropriate for disabled persons.

7. The Government seeks views and evidence on:

a. The case for and against targeted reform in relation to any of the possible exceptions to the principle of fairness and neutrality detailed in paragraph 5.6

b. Any other areas of trust taxation not mentioned there that would benefit from reform in line with the fairness and neutrality principle

CGT Private Residence Relief (“PRR”)
Trusts holding private residences as assets of the trust are no different from an individual owning them. If the residence is the main residence of the owner (rather than an investment property or holiday home) in the case of the individual, tax law provides an exemption from CGT on the disposal of the property whether those proceeds are invested in another property or given away to others. What matters is whether the property
qualified as the owner’s principal private residence (“PPR”). If it was not the owner’s PPR then the exemption does not apply and the disposal is taxable unless another exemption applied, such as a transfer between spouses/civil partners, which are transferred at no gain/no loss.

Trust tax treatment mirrors this in so far as it looks at who is occupying the property and assesses whether it is their PPR. If it is, other things being equal, then the trust is entitled to PRR and the proceeds of sale may be used for other purposes on a disposal just in the same way as the proceeds of sale of a PPR received by an individual may be used in any way. The only difference being that the trustees must use the proceeds in accordance with the terms of the trust and therefore the person occupying as his main residence may not receive the benefit of the proceeds.

Another difference, of course, is that trustees pay potentially a higher rate of CGT if the disposal is in part chargeable – namely, 28% compared to an individual who would pay a variable rate depending on the amount of their income so it could be as low as 18%.

Trusts providing a home for a beneficiary perform a useful and fair protection for vulnerable people incapable of owning their own home. They act as a means of carrying out a settlor’s wish to ensure the property ultimately benefits their children whilst at the same time discharging their moral duty to house their spouse or civil partner. Without similar CGT treatment to that of an individual, the sale by a trust owning a private residence for use and occupation by a beneficiary when a replacement property is needed would result in an erosion of the capital of the fund by CGT. This would leave less money to reinvest in a more appropriate property in contrast to an individual in similar circumstances.

There are many reasons why a trust might wish to dispose of a private residence and yet re-invest in a replacement e.g. the beneficiary has become frail and needs a smaller property within a suitably supported environment; a beneficiary needs to move to obtain work elsewhere; extra room is required to house a live-in carer.

Continued ownership of a private residence by a trust which is then occupied at different times by different beneficiaries as their PPR is no different to an individual owning a house and gifting it to their own child who occupies it as their PPR and gifts it to the next generation and so on.

**Trust Management Expenses**

Most trust management expenses are capital expenditure of the trust and come out of the capital fund of the trust. This mirrors an individual managing their own investments and paying for expenses related to this from their other cash resources.

Trust expenses which relate to particular sources of income, such as let property, enjoy the same treatment as an individual, which means the Income Tax Act 2007 permits
certain deductions against gross income before taxation e.g. repair costs and the fees of any managing agent.

Only trust management expenses which are entirely referable to income are deductible against the trust's gross income before taxation in the case of discretionary trusts; they are also deducted against gross income before distribution in IIP trusts so that the life tenant's income is reduced by any relevant trust management expenses (i.e. the life tenant is only taxed on the income to which they are entitled). It is therefore only discretionary trusts where some trust management expenses may be deductible before income tax is applied at the higher rates.

As to fairness, discretionary trusts pay more tax than an individual with the same amount of income because there is no personal allowance for trustees and no lower rates of tax applicable (save for £1,000 of gross income at the standard rate). There is also the added complexity of the management of the tax pool which has no relevance to an individual but is essential to ensure there is no double taxation in the management of the trust income.

**Trusts and transactions declared void by the courts**

This is another example of an area of law which has been thoroughly investigated by the courts in recent times. The case of *Pitt v Holt/Re Futter v HMRC* [2013] UKSC 26 reviewed the law on mistake and identified the correct basis on which decisions as to whether a mistake resulted in a void or voidable transaction should be made.

Tax should follow the event whether the parties to a transaction which is void are individuals, companies or trusts. There is no reason to have a special rule where trusts are involved and indeed we see occasion for considerably complexity and unfairness arising if the court set aside a transaction but HMRC refused to follow the tax consequences of this.

For example, if the court ordered that a gift into trust was to be set aside for mistake, would HMRC still intend to tax the trustees on that property even though they no longer have it? It should be borne in mind that the remedy to set something aside for mistake is discretionary and one that requires evidence. The courts will not readily countenance it to be used for tax avoidance purposes as Walker LJ pointed out in Futter. Having a more restrictive regime for trust mistakes is hardly furthering neutrality or transparency

**Other areas of trust taxation**

The ‘Frankland trap’ still applies in the situation where an IIP trust is created post 22 March 2006 during lifetime and is therefore within the relevant property regime. It the life tenant dies within three months of a 10 year charge the trust is caught by the trap, which was removed for immediate post death interest trusts. This problem needs to be addressed.
8. The Government seeks views and evidence on options for the simplification of Vulnerable Beneficiary Trusts, including their interaction with ‘age 18 to 25’ trusts

See above response to question 6 regarding our proposals for trusts for disabled beneficiaries and IHT transparent IIPs.

9. The Government seeks views and evidence on any other ways in which HMRC’s approach to trust taxation would benefit from simplification and/or alignment, where that would not have disproportionate additional consequences

We have set out our package of proposals for reform in our response to question 6.

Submitted by STEP UK Practice Committee and UK Technical Committee on 7 March 2019