Trust Review: CIOT response

Inheritance Tax and trusts | Personal tax

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CIOT has responded to HMRC's wide ranging consultation on the taxation of trusts.

HMRC's 'The Taxation of Trusts: a Review' issued on 7 November 2018 set out the three principles that the government said should underpin the taxation of trusts: transparency, fairness and neutrality, and simplicity. Recognising that the government was not making specific proposals and that this consultation was taking place at stage one of the consultation process, CIOT took the opportunity to explore various models as to how those might be reflected.

In terms of fairness and neutrality, we took a reasonable starting point to be that individuals with similar income and assets should pay the same amount in taxes. The corollary is that the yield to the Exchequer from taxpayers in similar circumstances should be the same. However a fundamental conceptual difficulty with any comparison between a trust and non-trust situation is that trusts involve the creation of different legal arrangements of ownership such that relevant individuals whether a settlor or beneficiary may have varying interests in the trust assets or entitlement to income. Their interests or entitlement differ both as between themselves and when compared to individuals who own assets outright or are entitled to income without limitation.

While recognising the conceptual difficulty of doing so (given the role that trusts occupy in the UK legal system and the increasingly complex dynamics of modern family life), we suggested that posing the question of what a truly neutral regime would look like was a useful exercise because it cast light on some of the more detailed issues that arise in considering reform of the current system.

A truly neutral regime would be one where tax made no difference to the 'trust or no trust' choice. Inevitably the relevant individuals are never in exactly the same position pre-tax, if a trust exists as compared to the non-trust scenario. But one model, we suggested, could (for example – and trying to minimise the violence done

to the fact that trusts are legally different arrangements) treat individual beneficiaries who are beneficially entitled to assets/income as fully owning them, and settlors as still owning assets/income that were subject to trustees' discretion.

Under this model, distributions out of discretionary arrangements prior to the settlor's death would be treated as gifts by the settlor; and assets subject to a discretion treated as part of the settlor's estate on death. The consequence would be the removal of the relevant property regime; the only IHT charge applicable (if any) would be on the settlor's death. Any tax on the trust per se would then be akin to a withholding tax on assets/income either within the trust or on being distributed, on account of final liabilities deemed to be the settlor's or his/her estate's, or the beneficiary's.

Such an approach might not necessarily be desirable (because, even in this 'hybrid' version, the deeming it would entail do not fully respect the fact that the legal position of trust-held assets is different from the no-trust scenario). In any event, it may be too big a change from the current approach to be practicable in any reasonable timescale. Nevertheless, it is instructive to reflect on what true neutrality would entail, particularly when considering such specific issues as a proposed professional services exemption, the interest-in-possession rules; and settlor-interested trusts.

Simplicity is highly desirable, but we recognised that in practice it is not always easy to achieve. Particularly since the introduction of the 2006 changes, the inheritance tax (IHT) regime has become far more complex both in terms of structure, and compliance. Given that those using express trusts will generally be better off and likely to have advisers in place, we suggested that if there is a trade-off between fairness and simplicity then – in the area of tax at least – a fair but complex measure may be preferable to a simple but unfair one.
Stability or consistency of approach should also be factored in, as trusts are longterm structures. Over-frequent changes to legislation leads to misunderstanding, and sometimes complex unfortunate consequences, for unrepresented taxpayers. It also leads to additional compliance costs for those who are professionally represented as well, as increased costs in reviewing and enforcing compliance for HMRC. This is particularly so in the absence of consultation.

We suggested that the efficacy of the implementation of the EU's fourth and fifth Anti-Money Laundering Directives in terms of achieving the government's

transparency objectives should be evaluated before further measures are introduced. We emphasised the importance of reasonable timescales for compliance, timely and clear guidance (particularly in relation to the definition of ‘legitimate interest’ for enquiries) and effective online processes.

We considered the UK’s current approach to defining the territorial scope of trusts for tax purposes particularly for corporate trustees and the provision of professional trustee services in the UK is both complex and lacking in neutrality. The current system provides significant tax disincentives to a foreign settlor who wishes to establish a trust in the UK. Enabling foreign settlors to set up trusts in the UK would create additional business opportunities for UK service providers with consequential increased tax revenues together with benefits as far as transparency is concerned.

We suggested that targeted reform to the IHT regime as it applies to trusts should be considered: we contrasted the low yield from lifetime transfers (charges within the relevant property regime in respect of relevant property trusts were £180m in 2017/18) with the £5bn raised from IHT death transfers. The level of complexity within the current trusts IHT regime does not seem justified by this very low yield. We suggested therefore the modelling of further alternatives, emphasising that alternatives should address trust taxation in the round, not IHT in isolation.

We reiterated the widely recognised opinion that vulnerable beneficiary trusts, despite reforms, remain complicated. We also suggested that consideration should be given to abolishing special regimes for children’s trusts (which are now only relevant on death, and settlors in these circumstances already have the option of a qualifying immediate post-death interest for such trusts). It would also make tailored and specific reform for disabled trusts easier to achieve if the taxation of trusts for children under 25 is not conflated with the taxation of disabled trusts (which cover a very different constituency). This is particularly the case given that their IHT regimes are already fundamentally different.

The CIOT response can be found on the CIOT website.