

The Taxation of Trusts Consultation

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INTRODUCTION

HMRC recently published a new consultation 'The Taxation of Trusts: A Review' considering whether the current system for taxing trusts meets the key principles of transparency, fairness, neutrality and simplicity. The consultation covers the three direct taxes which apply to trusts: income tax, capital gains tax and inheritance tax.

The consultation had been trailed in the Spring Statement 2018 following government concerns about the potential misuse of trusts – and in particular non-resident trusts - for tax avoidance purposes. Whilst acknowledging the numerous reforms over the years targeted at the use of overseas trusts by UK resident settlors, there are concerns that the current approach to trust taxation may “result in unfair outcomes or other unintended consequences”, but whilst recognising that there are many legitimate reasons why trusts should be used and that taxpayers should not be disadvantaged as a result of using trusts for these reasons.

TRANSPARENCY

HMRC acknowledges that the amount of information they hold on trusts has increased significantly in recent years, following the introduction of the Common Reporting Standard (CRS) and the Trust Registration Service (TRS). However, the government believes that further consideration is required in relation to trusts which are tax resident outside the UK where there may be an information deficit. There is likely to be an extension to the existing TRS regime for non-resident trusts following the implementation in the UK of the EU's 5th Anti-Money Laundering Directive. A further consultation on the detailed plans will be published over the winter of 2018/19.

The consultation also discusses the subject of the tax residence of trusts. Under current law, trusts are generally resident in the territory where the trustee (or the majority of the trustees if there are several) are themselves tax resident. Consequently, where a UK resident settlor of a trust appoints non-resident trustees, the settlement will usually be non-UK resident. Similarly (albeit unusual in

practice), a trust created by a non-resident settlor who appoints UK trustees will be UK resident.

The consultation asks for respondents to set out views and evidence regarding the territorial scope of the current tax rules which apply to trusts, and reasons why a UK resident settlor might use choose to use a non-resident (rather than UK resident) trust, and to what extent overseas trusts may be being used for tax avoidance or evasion. It appears that the government may be considering extending the scope of UK income tax/capital gains tax to overseas trusts through changes to the law on tax residence for trustees, but presumably limited to those settled directly or indirectly by a UK resident settlor or with UK resident beneficiaries. The government however acknowledges any attempt to take a different approach to the matter of trust residence would constitute a fundamental change to tax policy and would only be merited if there were a significant improvement to be gained in making a change.

FAIRNESS AND NEUTRALITY

The consultation acknowledges that the existing tax regimes for trusts produce a broadly neutral result taking into account the nature of the trust and who is benefitting from it in regard to income tax and capital gains tax. However, there are concerns that the current inheritance tax regime may give rise to non-neutral outcomes in some cases.

One particular point that is mentioned is the current regime for charging inheritance tax when property is settled on trust. At present, where a relevant property trust is created and the value of the property after reliefs exceeds the nil rate band (currently £325,000) any excess is usually taxed at 20%. A further charge of 6% then applies on each 10-year anniversary of the trust and/or when assets are distributed from the trust (the “exit charge”). Over a 30-year time period (i.e. around one generation), the total IHT charge on a trust of 38% is broadly equivalent to the 40% rate which applies to the estate of an individual on death. However, if the settlor remaining life is either much shorter or greater than 30 years then there could be a significant discrepancy in the overall IHT charged on those assets.

The consultation also recognises that the upfront 20% charge represents a significant disincentive to settle assets on trust. However, no specific alternative bases of calculation are postulated.

Whilst acknowledging that lifetime gifts of any value which are made to an individual are generally exempt from IHT if the donor survives 7 years after making the gift, HMRC queries whether the current trust IHT regime of entry charges and periodic charges is achieving the policy objective of revenue neutrality. The consultation asks for views on the case for an against targeted reform to the IHT regime as it applies to trusts, but interestingly does not ask for views concerning any possible change to the currently unlimited exemption for lifetime gifts between individuals.

Under the banner of ‘fairness and neutrality’, the government also queries whether certain types of trust should still be able to benefit from Principal Private Residence relief where a beneficiary occupies a residential property held in trust, and whether trust management expenses should continue to be generally deductible from trust income for income tax purposes. Finally, the consultation queries whether it is fair that the Courts can allow settlors/trustees to have certain transactions set aside which resulted in unanticipated tax liabilities for the parties involved (‘Hastings-Bass’). Changes to these aspects are clearly matters that the government is actively considering.

SIMPLICITY

HMRC recognises that the complexity of the trust tax framework discourages the use of trusts for those they are intended to benefit, citing in particular trusts for beneficiaries with a disability or those for bereaved minors. The government therefore invites views on possible simplification of the tax regime applicable to “vulnerable beneficiary” trusts, as well as ways in which the approach to trust taxation could be simplified without having disproportionate consequences.

CONCLUSION

Whilst the consultation does not put forward any firm proposals for reforming the taxation of trusts, the questions posed and the surrounding commentary give clues as to the direction of HMRC’s thinking. That said, with the Government’s attention focussed almost entirely on Brexit negotiations and with the threat of a general

election in prospect, the current consultation may result in little in the way of change to the tax framework for trusts for some time to come.

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