Low Incomes
Tax Reform
Group
A voice for the unrepresented

HM Revenue & Customs' (HMRC) consultation
The Taxation of Trusts: A Review
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

1.1 We are pleased to be able to provide input into this consultation on the taxation of trusts. In particular, we welcome HMRC's decision to consult at an early stage and for being prepared to listen to the concerns of professionals. While the general public might view trusts as being the prerogative of the rich, in fact many ordinary people are the beneficiaries of trusts over their lifetime as a result of benefitting from someone's estate or from their pension or life assurance policies being written in trust, for example. Accordingly, trusts are very common and the taxation of them is something that has general application.

1.2 Our response primarily focuses on the taxation issues that might affect vulnerable or low-income beneficiaries or settlors, although occasionally we have more general points to make. Accordingly, we have not answered all of the questions raised, but have provided background information and commentary.

1.3 On the basis that this is a consultation very early in the process, rather than suggesting specific changes to legislation, instead we have focussed on principles.

1.4 We recommend that the taxation of estates in administration is simplified, particularly simple estates, by treating them as 'look through'.

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1.5 We also suggest that where trust income is distributed, it should never be taxed on the trustees, but on the beneficiary, accepting there may need to be some other regime for settlor interested trusts.

1.6 Personal injury trusts are created at a time when an individual is likely to be vulnerable, if only because they have come into a significant sum of money. We recommend that consideration be given to changing the tax regime affecting such trusts, particularly with regard to the relevant property regime.

1.7 The tax regime, and the restrictions on payments to other beneficiaries, in particular, can put unnecessary strictures on trusts for the disabled. We recommend a root and branch review of the desired uses of such trusts and that legislation is drafted to ensure the best outcome for the disabled beneficiary. Of course, we accept that if trust assets were applied for someone other than a disabled beneficiary there might be less favourable tax consequences, but that should not prejudice the balance of trust assets.

1.8 Our comments relate solely to UK trusts although we do accept that some of the people we represent will receive income and/or capital from foreign trusts.

1.9 We are generally supportive of the comments made by our colleagues in CIOT and ATT.

2 About Us

2.1 The LITRG is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HMRC and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT’s primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 General comments on the existing taxation regime for trusts

3.1 From the point of view of a low-income or vulnerable beneficiary, the taxation of trusts, or indeed any income they receive from trusts, can be baffling. For example, the trustees may have paid tax, but the beneficiary may be able to claim some or all of it back.

3.2 While we can understand the government's reluctance to reduce the taxation paid in relation to the capital and income of trusts at the present time, we are concerned that some beneficiaries are losing out on funds that would be very valuable to them due to a lack of understanding of the nature of payments made to them and the associated taxation consequences. In other words, they may not understand that they could reclaim tax on the trust distributions, or may not know how to do this.

4 Comments on some specific types of trusts

4.1 *Taxation of Estates in Administration*

4.1.1 The rules for taxation of income arising in estates in administration follow the normal rules, with no personal relief being available to the trustees but income being chargeable at the basic rate or the dividend ordinary rate, for example. In other words, the executors or personal representatives are liable for tax on any income received by the estate, with no savings rate or dividend nil rate band.

4.1.2 When that income is received by the beneficiary (net of tax), the beneficiary may be able to utilise their personal allowance against the income. We suspect many such beneficiaries would not reclaim the tax that had already been paid if their total income for the year is less than their personal allowance. In addition, it seems likely that many low-income taxpayers will miss out on the opportunity to have some of the income taxed at a lower rate since they fail to understand the effect of the savings or dividend nil rate bands. For those whom we represent even a relatively small amount of income can make a difference. A further issue arises where a beneficiary has a discretionary interest in the residue of an estate due to a discretionary trust having been established under the will: in this case any distribution of estate income is treated as arising from the discretionary trust meaning that it is treated as arising from one source. As with other distributions from discretionary trusts the beneficiary would be unable to use their savings or dividend nil rate bands against such income.

4.1.3 A formal administration period is probably only necessary where there are several beneficiaries, several sources of income or there may be some dispute. In other cases, particularly with low-income estates (with no or very minimal expenses chargeable to income), it seems likely that assets could be transferred to beneficiaries, together with any income that had arisen in the meantime and that income reported as the beneficiaries' own.

4.1.4 While this may not be strictly correct under the existing legislation, it is certainly expedient and probably happens regularly at the moment. We would suggest that in the case of estates where there is no need to apply for probate and no inheritance tax to pay, there should be a statutory option to 'look through' the estate and report the income as belonging to the ultimate beneficiary. This is slightly more radical than the existing position where we

understand HMRC operate informal procedures,[1] accepting a single computation and one-off payment of an estate's income tax and capital gains tax liability if:

> (i) the total liability over the whole of the administration period is no more than £10,000;
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> (ii) probate value is no more than £2.5 million;
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> (iii) the proceeds of assets sold in any one tax year are no more than £500,000 (£250,000 for deaths before 6 April 2016); and
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> (iv) the estate is not regarded as complex, such that it can be dealt with without the personal representatives having to complete a return.

4.2 ***Personal Injury Trusts***

Rationale for such trusts

4.2.1 When an award for personal injury or medical negligence, for example, is made, it is often paid into a personal injury trust. This is essential if the injured party or a member of their family is claiming or may be required to claim means-tested state benefits in the future as any income or capital in the trust is ignored for these purposes. These trusts also enable local authority care to be provided without taking into account the value of funds in the trust.

4.2.2 Because there will normally be at least two trustees, one of whom may be the injured party, there is a degree of external control over the funds that may be useful if the injured party cannot always make rational decisions for themselves. If the injured party has suffered cognitive impairment, the role of the trustees becomes even more important. Appropriate trustees can provide valuable advice and support when making important decisions. This can ensure that funds are managed properly to protect the person's long term interests since the award is intended to provide support for the remainder of the individual’s life.

4.2.3 The trust will have the injured party as the primary beneficiary (or even sole beneficiary) with some trusts also naming others as a further class of beneficiaries. Ring-fencing the funds in a trust protects the funds from being used for any other purpose or being subject to claims from other family members, for example.

Tax status of personal injury trusts

4.2.4 These trusts are, most commonly, set up as bare trusts – in other words the underlying capital and any income arising belongs absolutely to the primary beneficiary. Bare trusts are

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[1] HMRC Trusts, Settlements and Estates Manual TSEM7410; HMRC Trusts and Estates Newsletter, August 2018 at www.gov.uk/government/publications/hm-revenue-and-customs-trusts-and-estates-newsletters

used because they are simple, but also because in the case of larger amounts of damages, there would be an IHT entry charge[1] into a relevant property trust.

4.2.5 Because the funds in these trusts are treated as being settled by the primary beneficiary, there are no income tax or capital gains tax advantages to the trust (unless they qualify as a trust for the disabled or vulnerable) and, if they are bare trusts, the assets form part of the primary beneficiary's estate for IHT purposes.

4.2.6 The assets in the bare trust forming part of the individual's estate for IHT purposes can cause issues where the primary beneficiary is unable to make a Will or chooses not to do so. The funds might then pass to distant or inappropriate family members (for example, those unable to manage their financial affairs successfully).

4.2.7 A relevant property (discretionary) trust might enable funds within the trust to be used for other family members, subject to the agreement of the trustees. For example, where the trust is primarily for a child, funds might be able to be used to enable their siblings to go on holiday without the primary beneficiary of the trust – providing the siblings, and possibly their parents, with some respite and enabling better overall care to be provided to the primary beneficiary once the rest of the family is refreshed. Indeed we understand that the £3,000 'exemption' provided in the disabled/vulnerable trusts regime[2] was intended to provide for instances like this but, arguably, the limit is set too low for many families.[3]

4.2.8 On the death of the primary beneficiary, the funds in a relevant property trust would remain within the trust to be used for the other classes of beneficiaries. This could be beneficial for those beneficiaries as the trust funds would not form part of their estate for IHT purposes, nor be available to a divorced spouse, for example. It could also protect the new beneficiaries from being exploited.

4.2.9 Of course, what does need to be borne in mind is that the award may often be fully utilised during the life of the primary beneficiary so that there are no funds remaining on their death in any case.

4.2.10 Such trusts are subject to the settlor interested rules and we consider that may not be appropriate. The funds normally arise from third parties, for example insurance companies or the Criminal Injuries Compensation Fund, often as a result of negligence of a third party,

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[1] Where value is added to a relevant property trust, if that exceeds the available IHT nil rate band of the settlor (maximum £325,000), there is an immediate charge to IHT amounting to 20% of the 'excess' value placed in the trust.

[2] As introduced by FA 2013, section 216 and Schedule 44

[3] See also our paper commenting on these proposals before FA 2013 was passed: https://www.litrg.org.uk/latest-news/submissions/130212-trusts-vulnerable-beneficiary-—-finance-bill-2013-draft-clauses

and we suggest it may be appropriate not to regard these trusts as settlor-interested. That would remove a great deal of complexity for larger awards.

4.2.11 Awards in personal injury cases are designed to take account of the long-term needs of the individual, whether it be capital needs (for example, in building or renovating a suitable property) or income needs (for example, in replacing lost earnings). It does seem inequitable that the choice of a different trust type might significantly reduce the value of funds in the trust (due to the entry charge to a relevant property trust).

4.3 ***Trusts for the disabled***

4.3.1 The regime was changed significantly from 2004/05 and again in FA 2013.

4.3.2 Some of these trusts will be self-settled – for example, by an individual diagnosed with a condition that is expected to deteriorate; while others will be established by third parties – for example by a parent for their child(ren).

4.3.3 Provided the trust conforms with the legislation there are special provisions for income tax, capital gains tax and inheritance tax, designed to lessen the burden of these taxes. Some of the conditions in the legislation are particularly onerous, particularly with regard to the sums that may be paid to any other beneficiary of the trust – broadly an annual limit of the lower of £3,000 or 3% of the value of the trust.

4.3.4 At the time the trust is established it can be difficult to assess the future needs of the beneficiary. If the settlor has other family members to provide for, they may wish to provide some flexibility in the trust deed so that other beneficiaries may have income and/or capital paid to them. This might be the case for many settlements whether self-settled or settled by a third party.

4.3.5 Accordingly, many settlors choose not to establish a trust for the disabled and opt for more flexibility, albeit that might mean the tax regime is more burdensome.

4.4 ***Trusts for bereaved minors***

4.4.1 It is clearly sensible for a parent to make provision in their Will for their children. Where these children are still young, it is natural that the parent would seek to protect the children's inheritance both from profligate spending by the child, but also from the grasp of other people seeking to exploit the child's wealth. A trust is therefore a suitable option. A special inheritance tax regime applies to such trusts until the young person is age 18. While that young person may enjoy many adult activities at that age, we suspect most parents would consider that age 18 is very young to be able to handle a significant sum of money. We recommend that the special inheritance tax regime for bereaved minors be extended to age 25.

5 Other comments

5.1 Some of the people we represent will receive distributions from trusts. In many cases they may be able to claim tax refunds, although some may not make the claim due to ignorance or the complexities of making the claim.

5.2 One problem connected with such refund claims is that form R40 that would commonly be used to make such a claim cannot be filed online unless the individual has a government gateway sign in or has managed to register with Verify on GOV.UK. Many young or vulnerable people will be unable to do this, meaning that a paper form has to be used. This adds to the administration for a beneficiary. We recommend the system be simplified so that beneficiaries might report their income by telephone, as an alternative, up to certain limits, in a similar way that employment expense claims may be made by telephone.

5.3 It appears that the income tax rates applicable to trusts were put in place to disincentivise people from settling sums into trust. Indeed, the discussion paper on income tax issues as part of the series on Modernising the Tax system for Trusts[1] seems to support this. When income from the trust is paid out to beneficiaries, though, the income is taxed on the beneficiaries and it is difficult to see why the income has also to be taxed on the trustees. We recommend this be simplified, perhaps by restricting taxation on the trustees to income and/or gains retained within the trust

5.4 Although trusts are often used to hold pension policies and so on, many of these would not be recognised as trusts by the man in the street. Accordingly, trust legislation needs to be examined critically to remove complexities such as para 2 Sch 1 TCGA 1992 that seeks to restrict the annual exemption for trustees depending on the number of trusts established by the settlor. We would suspect such measures bring in little additional revenue, but add significant complexity.

5.5 We understand the Law Commission is about to undertake a review of Modernising Trust Law for a Global Britain.[2] In addition, the Office of Tax Simplification has just published a first report on Inheritance Tax.[3] It would make sense for the taxation of trusts, tax law and inheritance tax to be considered together rather than piecemeal.

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[1] https://webarchive.nationalarchives.gov.uk/20040722033246/http://www.inlandrevenue.gov.uk/trusts/trust-modernisation.htm

[2] https://www.lawcom.gov.uk/project/modernising-trust-law-for-a-global-britain/

[3] https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review

6 Response to the questions raised in the document

6.1 ***Question 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.***

6.1.1 It would seem difficult to argue against these principles, but we question whether they are equally applicable to all trusts. For example, is it important to have the same tax regime for a trust set up for a wealthy family as a trust set up to protect a disabled or vulnerable beneficiary? Both trusts may be set up for good reasons but we question if it is fair or neutral to potentially treat the two in the same way. Indeed, the current tax regimes for these types of trust are different. Accordingly, we suggest that it may be better to look at the particular intention of the trust in order to determine what is fair. We accept that a trust for a disabled beneficiary may change in nature at a future point and at that stage the tax regime applying to it may change. We support the statement at 3.10.2 in the consultation document that the tax treatment of trusts should neither encourage nor discourage their use.

6.2 ***Questions 2, 3, 4 and 5***

6.2.1 These relate mainly to offshore trusts and trust residence and we are unable to answer these points, concentrating as we do on low-income and vulnerable taxpayers based in the UK, although we do accept that some of those we represent may receive distributions from such trusts.

6.3 ***Question 6. The government seeks views and evidence on the case for and against targeted reform to the Inheritance Tax regime as it applies to trusts; and broad suggestions as to what any reform should look like and how it would meet the fairness and neutrality principle.***

6.3.1 We have noted above at 4.2.4 that the relevant property regime is the main reason why personal injury trusts are established as bare trusts. Given that these trusts are treated as settlor-interested, it seems anomalous that an entry charge should arise if a personal injury trust were established as a discretionary trust, for example. Such a trust could provide greater protection to the beneficiary than a bare trust and may only be established in specific circumstances. It would seem fair to the injured party that the tax regime should not penalise them for being the recipient of funds that they have received as recognition of another person's fault or mistake.

6.4 ***Question 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 at 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.

6.4.1 Of the points raised in the consultation document the only one that we consider might have reasonable widespread application among the people we seek to represent is Private Residence Relief. Currently this applies, broadly, where trustees dispose of a dwelling that has been occupied as the only or main residence of a trust beneficiary.

6.4.2 For many years Wills were written so that a surviving spouse had rights to remain in a property for life (or possibly until remarriage) – at which time the property would devolve to other family members. One of the simplest ways of achieving this was to place the home in a trust. The trustees could allow the beneficiary to move to a more suitable property, if necessary, while ensuring the property passed to the required beneficiaries in due course. No tax loss ensued.

6.4.3 Now that many families are more fluid, it is common for children from more than one set of parents to live as part of a family household. When such households come together, the individual parents may have views on how their wealth should be distributed in the event of their death, while ensuring that their surviving spouse/civil partner/unmarried partner retains the right to live in the family property. Various family members may be protected in this way. For example, sometimes this is a way of a grandparent ensuring that some of their assets pass to a grandchild with whom they may have little contact.

6.4.4 It seems to us that these are suitable ways for a trust to be used – protecting a surviving spouse/partner while ensuring assets ultimately pass to another beneficiary. If HMRC have concerns that PRR is being misused in other ways then we suggest that targeted anti-avoidance legislation would be a far more suitable remedy instead of curtailing PRR for all trustees.

6.5 ***Questions 8 & 9.***

6.5.1 We do not offer advice and so cannot offer evidence. Any comments we have are contained in the narrative above at section 4.

LITRG
20 February 2019