HMRC consultation on vulnerable beneficiary trusts

LITRG response

1. Executive summary

1.1 We welcome the opportunity to comment on these proposals, which we see as an opportunity to produce a regime in which vulnerable and disabled beneficiary trust arrangements can be tailored to the needs of the beneficiaries rather than compliance with a set of rather arbitrary tax rules, particularly as different and sometimes conflicting rules apply to different taxes.

1.2 Trusts are one way to protect the property of individuals who would be at risk of exploitation or other disadvantage if they were left to manage their own affairs. It is vital to preserve the freedom of beneficiaries and their carers to choose the most appropriate means of achieving this, without interference from an over complex tax system.

1.3 The starting point in considering any change is that disabled beneficiaries should not be taxed any more adversely than if they owned the property themselves. All reform to the tax system should be tested against this premise. At present the system fails in this objective in a number of respects.

1.4 A simpler tax system needs to be introduced for disabled beneficiary trusts. Tax avoidance is not a motive we have ever seen for setting up a disabled trust given the strict rules governing them.

1.5 We believe that the definition of 'vulnerable person' should be wide enough to encompass all those who need the protection afforded by such trusts. In addition to the categories of individuals mentioned in the consultative document, these would include those who lack

CHARTERED INSTITUTE OF TAXATION
1st Floor, Artillery House, 11-19 Artillery Row,
London, SW1P 1RT

REGISTERED AS A CHARITY NO 1037771

Tel: +44 (0)20 7340 0550
Fax: +44 (0)20 7340 0559
E-mail: litrg@ciot.org.uk
www.litrg.org.uk

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capacity owing to a degenerative or fluctuating condition and those for whom the Court has set up trust arrangements – for example, as a receptacle for an interim award of damages.

1.6 The consultation document proposes to use the enhanced rate of the daily living component of PIP as a qualifying criterion. It would though be wrong to *restrict* entitlement to so narrow a criterion and the modelling described in the consultation document shows that both rates of the daily living component of PIP would be a better match to the present DLA criteria. The present attendance allowance criterion should, of course, remain in place.

1.7 In our view, a fair and straightforward definition would be set out in three stages:

- anyone in receipt of the daily living component of PIP at either rate should automatically qualify, as should anyone in receipt of attendance allowance;
- a secondary qualification would be a diagnosis of one of a list of conditions specified in a statutory instrument;
- if neither of the above applied but an individual was clearly vulnerable in the sense of needing the protection of a trust, certification by a lawyer or doctor should suffice.

1.8 To determine mental capacity for the purposes of a new definition of vulnerable person, the current test appears to be satisfactory in the light of discussions we have had with officials. An equally acceptable alternative would be linking it to section 2 of the Mental Capacity Act 2005.

1.9 We see no obstacle at all to requiring that during the lifetime of the vulnerable beneficiary the trust property should be applied wholly or mainly for his or her benefit. We think, however, that gifts to friends, carers or relatives of the vulnerable person, or expenditure on or for a carer (for example, to take a respite break, or accompany the vulnerable person on holiday) should not be ruled out and the legislation and official guidance should make this clear.

2. Who we are

2.1 The Low Incomes Tax Reform Group (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.

2.2 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of the CIOT's key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties.

3. General comments

3.1 We welcome the opportunity to comment on these proposals to review the definition of vulnerable person for the purposes of vulnerable beneficiary trusts, and other qualifying criteria, following changes to the benefits system.

3.2 Trusts are often a convenient and appropriate way to protect the property of beneficiaries who would be at risk of exploitation or other disadvantage if they were left to manage their own affairs. There may be other ways of achieving this in some circumstances; but it is vital that the beneficiaries and those who care for them should be free to choose the most appropriate form of protection for them, without interference or distortion from an over complex tax system.

3.3 The starting point in considering any change is that disabled beneficiaries should not be taxed any more adversely than if they owned the property themselves. All reform to the tax system should be tested against this premise.

3.4 At present the system fails in this objective in a number of respects both during the lifetime of the beneficiary and on death. The anomalies which tax disabled trusts more severely than an individual need to be removed. In particular we refer to the penal double tax charge to both capital gains tax and inheritance tax on the death of a disabled beneficiary where assets are held in trust and the very complex and anomalous rules that can arise if a vulnerable beneficiary election is made for income tax and capital gains tax purposes.

3.5 Different and sometimes conflicting rules apply to different taxes. As HMRC is aware, the rules governing disabled trusts are not even the same between different capital gains tax reliefs let alone capital gains tax, income tax and inheritance tax reliefs.

3.6 The consultation document does not make any attempt to consider these issues but they are relevant if the Government is serious in making the taxation of disabled trusts fairer.

3.7 We are also unconvinced that income tax and capital gains tax rules governing a trust for orphaned minors will necessarily be appropriate in relation to a trust for disabled beneficiaries.

3.8 The vulnerable beneficiaries tax regime with its insistence on tax pools, and the differentiation between settlor and non-settlor interested trusts and the various complex conditions imposed is rarely used in practice. As HMRC noted, very few elections have been made by disabled trusts. The legislation needs to be rethought and a simpler tax system introduced for disabled beneficiary trusts.

3.9 Tax avoidance is not a motive we have ever seen for setting up a disabled trust given the strict rules governing them. As noted in paragraph 8.3 of the consultation document, HMRC's own research indicates that the main motivation for setting up a private trust is to control assets for the benefit of individuals or groups of individuals, typically within a family.

3.10 The changes to the legislation on disabled trusts in 2006 were driven by a perceived need to counter the use of trusts for avoidance purposes rather than preserving the right of beneficiaries and their carers to choose how best to arrange their affairs. We sincerely hope

that this consultation will produce a regime in which vulnerable and disabled beneficiary trust arrangements can be tailored to the needs of the beneficiaries rather than compliance with a set of tax rules.

4. The questions in the consultation document

Q1. *Do respondents consider that vulnerable people have distinguishing characteristics outside of the two groups outlined at paragraph 3.3? If so, what are they and why?*

4.1.1 We assume the question should refer to paragraph 3.4, where the two groups are defined as:

- those who require a trust arrangement in order to secure protection from their own behaviour or lack of ability (because, for example, the individual is unable to understand everyday financial matters sufficiently well to cope with the ownership of property), and
- those who require property to be protected from others (because, say the individual is at risk of abuse, exploitation, coercion or persuasion).

4.1.2 Any revised definition should be so drafted as to include the following categories of individuals, whether or not as part and parcel of the above characterisation.

- Those who are currently able to manage their own affairs but foresee a time when they might not be, for example because they suffer from a degenerative condition. This is the type of individual who is able to self-settle under IHTA 1984, section 89A; they do not require a trust arrangement now, but wish to set one up now in readiness for when they do.
- Those who are likely to lose their capacity in the future and for whom others (parents, relatives, friends) wish to settle property in readiness for that time. This might include, for example, children with Down's syndrome whose parents wish to settle property on them in readiness for a time when the parents may no longer be around or indeed able to look after them.
- Those who suffer from a fluctuating condition (for example, bipolar disorder) and so experience times when they are able to manage their own affairs and times when they are not.
- Those for whom trust arrangements have been set up by a court – for example as a receptacle for interim awards of personal injury damages.

Q2. Do respondents have suggestions for defining a 'vulnerable person' for tax purposes other than by reference to orphaned minors and those with a severe physical or mental disability?

4.2.1 We would very much caution against use of the word 'severe' as (for example) a fairly mild, or moderate, state of dementia could lead to a person being incapable of managing his or her own affairs. And while orphaned minors are self-evidently 'vulnerable' because of their legal incapacity, a different form of incapacity might continue into adulthood where, for example, the minor has a learning disability.

4.2.2 Clearly, defining a 'vulnerable person' for tax purposes needs to take into account all for whom a trust arrangement is either desirable or necessary. Some might argue that a person who is vulnerable could equally well benefit from a suitable power of attorney or a Court of Protection order, but it is not the function of the tax system to dictate what type of arrangement the person should use for his or her own protection. If, having surveyed the alternatives, the vulnerable person – or his or her advisers or protectors – decide that a trust arrangement is the most suitable, they should be free to choose that route without the tax system putting barriers in the way.

4.2.3 At 3.7 the consultation document states, quite rightly, that while disabled or elderly people, or those with a legal impediment to owning property, should not automatically be regarded as 'vulnerable', there may be other groups not yet identified in research who can be so regarded. Therefore, an objective test to defining a vulnerable person (such as being in receipt of, or entitled to, some benefit) might be a useful starting point, but would only take us so far. Some who need to use trusts might qualify automatically through such a test, but others who also need to use trusts might not, and for them one or more additional tests might be needed.

4.2.4 There is no need, in our view, to make the test too restrictive. The tax advantages of using a vulnerable trust amount to no more than the right for the individual beneficiary to be taxed on the assets in the trust as though they were his or her own assets – in other words, all they escape is the added tax charges associated with most trusts, such as the 50% income tax rate and the inheritance tax exit and periodic charges to inheritance tax.

4.2.5 Unsurprisingly, therefore, there is no evidence that disabled or vulnerable trusts are widely used for tax avoidance purposes. Equally, because of the restrictions that vulnerable trusts place upon the beneficiary's use of the trust property – including the further restrictions proposed by chapters 5 and 6 of the consultation document – it is hard to see how anyone would actually want to set up such a trust unless it was necessary for his or her protection.

4.2.6 Bearing that in mind, what should be the starting point for a definition of 'vulnerable person'?

4.2.7 The present categories of the vulnerable person definition are set out in paragraph 2.9 of the consultation document: namely, a person:

- incapable, by reason of a mental disorder within the meaning of the Mental Health Act 1983, of administering his or her property or managing his or her affairs; or
- in receipt of attendance allowance; or
- in receipt of the highest or middle rate care component of disability living allowance.

4.2.8 The proposal in the consultation document is to use the enhanced rate daily living component of PIP as a test 'in the first instance'. We would strongly oppose making it the sole test, as that would immediately narrow down the numbers of people able to use vulnerable trusts by a very substantial margin. Paragraph 8.6 describes modelling that shows some 540,000 claimants expected to be entitled to PIP daily living component at the

enhanced rate, as against 1,310,000 entitled to DLA care component at the highest or middle rate. That suggests some 770,000 fewer people potentially entitled to vulnerable trust treatment than now, and it would be regrettable indeed if that number included individuals who were genuinely vulnerable. In fact the figures quoted in paragraph 8.6 suggests that a far fairer and more accurate test, and a closer match with the current test, would be both the standard and enhanced rate of PIP care component to which a projected 1,230,000 will be entitled.

4.2.9 It is also essential that the present qualifying criterion of receipt of attendance allowance should be retained to enable vulnerable people of 65 and over to qualify.

Our proposed definition

4.2.10 Our proposal involves three steps.

- *Step One* would be to passport anyone in receipt of the daily living component of PIP or attendance allowance at either rate to vulnerable trust treatment, and to retain passporting from DLA for those who will remain on DLA after PIP is introduced – such as the over 65s who started on DLA before their 65th birthday, and children under age of 16. That would be our starting point. If it was decided to include those with a 'severe physical disability' it might also make sense to include those in receipt of the mobility component of PIP. At present eligibility is confined to those actually in receipt of the relevant component of DLA, but that leaves out a significant number of people who choose not to claim DLA, often because they do not think it right that they should be a 'burden on the state' when they have their own resources. To ensure that such people are not left out, and to bring in others who are not entitled to the relevant benefit but are still vulnerable, we would recommend a further two steps.
- *Step Two*: if and to the extent that a person does not qualify under Step One, they can still qualify as a beneficiary of a vulnerable trust if they have been diagnosed with one of a list of conditions specified in a statutory instrument. The list could draw on some of the existing enactments defining 'vulnerable adult' such as those referred to in paragraph 3.8 of the consultation document, but should at any rate include degenerative or fluctuating conditions such as those we refer to at paragraph 4.1.2 above in answer to Q1. The statutory instrument containing this list would need to be published in draft for consultation, and we would be pleased to help with that process: provided the consultation was completed by the end of February 2013, it would be possible to lay it before Parliament in time for it to come into force in early April.
- *Step Three*: if and to the extent that an adult needs the protection of a trust but does not fall within Step One or Step Two (this would probably be quite rare), they could benefit from a qualifying vulnerable trust if their need for one was certified by a lawyer or doctor known to the beneficiary or his or her family.

4.2.11 In terms of the criteria set out in paragraph 2.3 of the consultation document, the three step test we propose above would be:

- fair, because nobody who needed the protection of a trust would be left out;

- simple to understand and straightforward to administer, because the vast majority would qualify either because they were entitled to PIP or because they were diagnosed with a specific condition;
- target relief where it was most effective, because it would include everyone who needed the protection of such a trust;
- not open to abuse, for the reasons we give in paragraphs 3.9 and 4.2.5 above, and also because of the proposed restriction in who apart from the vulnerable beneficiary could benefit from the capital or income in the trust (see below in answer to Q10 and Q11).

Q3. In relation to those suggestions, what practical issues do respondents envisage applying them in the context of a self-assessed tax; and how could they be overcome?

4.3.1 It should be clear to the trustees whether their beneficiary is eligible for PIP as the criteria will be set out in DWP sources, and whether the beneficiary has been diagnosed with one or more of the conditions listed in Step 2 will be a question of fact. Practical problems might arise if neither the Step 1 nor Step 2 conditions are satisfied and it is necessary to obtain the certification of a doctor or lawyer, but we think such situations would be rare.

4.3.2 Problems might also arise if the beneficiary were to recover from the condition that made them vulnerable. It would be necessary, as now, to rely on the trustees to report the fact and to revoke the vulnerable trust election. But if the condition were one from which a full recovery was expected, it is unlikely that a trust would be a suitable vehicle for looking after the vulnerable person's property in the meantime.

Q4. Do respondents agree that including recipients of the enhanced rate daily living component of PIP within the vulnerable person definition would achieve certainty in the same way the existing reference to DLA does?

4.4.1 It would achieve certainty, but we see no virtue in that if the test itself is inadequate. We explain above why restricting the test to the enhanced rate of PIP daily living component would leave out many who would currently qualify, and why it should be opened out at least to both rates of PIP daily living. The three-step test we propose would be both certain and comprehensive.

Q5. Would including recipients of the enhanced rate daily living component of PIP within the vulnerable person definition be an effective category to support the targeting of the tax treatment for those beneficiaries with a severe physical or mental disability?

4.5.1 Restricting the test to the enhanced rate daily living component would be insufficient for the reasons discussed. The test should embrace at least both rates of the daily living component, and consideration should be given to including the mobility component too, if it is intended to include those with a severe physical disability.

Q6. What are respondents' views on whether the proposal for PIP might lead to a suitable test, or part of a test, for assessing whether someone should be able to benefit from access to the tax treatment for vulnerable persons' trusts?

4.6.1 We have explained in our answer to Q2 that we think entitlement to PIP can form a part, perhaps the main part, of a suitable test.

Mental incapacity

Q7. Is the existing mental incapacity test suitably targeted? If not, why not?

4.7.1 In previous discussions with HMRC in 2010 we reached the conclusion that the following conditions count as 'mental disorder' under the Mental Health Act 1983 and enable a person to qualify as 'vulnerable', if as a result of having the condition they are incapable of managing their affairs:

- Alzheimer's or other forms of dementia;
- Bipolar disorder, schizophrenia, depression or other mental illness;
- Autism (although normally described as pervasive developmental disorder);
- Learning disability, such as those with Down's syndrome.

4.7.2 We also concluded that while brain injuries per se were not a mental disorder (they may only have physical consequences such as loss of movement or muscle control), psychological, cognitive or behavioural disorders associated with or caused by brain injuries are mental disorders.

4.7.3 Similarly, while Parkinson's per se is a neurological condition rather than a brain disorder, we concluded that like brain injuries it can lead to psychological, cognitive or behavioural disorders that are mental disorders (such as dementia).

4.7.4 If this is accepted, and confirmed in guidance available to trustees, then the current test seems to be suitably targeted.

Q8. What alternative approach would respondents propose and why?

4.8.1 In the consultations and discussions surrounding the Finance Bill 2006, we took the view that section 2 of the Mental Capacity Act 2005 afforded a better test of whether a person lacked capacity, for the very reason that it was capable of focusing on a person's capacity to manage or administer their property and deal with their everyday financial affairs (paragraph 4.5 of the consultation document refers).

4.8.2 We would have no objection to restricting the test accordingly, but we doubt the necessity for doing so given that the very purpose of setting up a vulnerable trust is to cater for precisely that sort of incapacity. If a person experienced some other form of mental incapacity, but was perfectly adept at managing their affairs, what possible reason could there be for going to the trouble of setting up a trust for them?

4.8.3 Similarly we see no need to restrict the application of the test to those with a permanent or long-term lack of capacity, because if the person were expected to recover from the condition causing the lack of capacity within the short to medium term, setting up a trust would probably not be the most suitable way of dealing with the problem.

Q9. What practical issues do respondents experience when applying the current 'mental incapacity' test, or envisage with any alternative; and how could they be overcome?

4.9.1 If a problem arose in assessing a person's capacity, normally the opinion of a medical practitioner would be sought. This would not necessarily require a doctor – a community nurse or similar would equally be able to give such a certification.

4.9.2 Full and detailed guidance on assessing capacity is available from a number of sources so we do not envisage any particular problems arising, any more than they do now.

Q10. Do respondents see any reason why the 'application of capital' conditions should not require the vulnerable beneficiary to benefit from every application of the capital during the lifetime (or other relevant period) of the vulnerable beneficiary (with consequent changes to the provisions disregarding trustees' general statutory powers of advancement)?

4.10.1 We agree that allowing up to half the trust property to be applied for the benefit of non-vulnerable beneficiaries rather defeats the object of having a vulnerable trust. The trust property needs to be applied wholly or mainly for the benefit of the vulnerable person.

4.10.2 However, applying trust property for the benefit of another can indirectly benefit the vulnerable person. For example, the trustees may wish to pay for a holiday for a carer to provide them with respite, or they may decide to pay for a carer to accompany the vulnerable beneficiary on holiday. Or the beneficiary may wish trust money to be spent on a present for a carer, friend or relative, and the trustees may decide that would be an appropriate trust expense.

4.10.3 The legislation should not be drawn in such a way as to impede the trustees' use of their discretion to incur such expenditure, which would normally be small in comparison with the size of the trust fund. Moreover, it should be made clear in official guidance that such expenditure on others can be legitimate.

Q11. Do respondents see any reason why the 'application of income' conditions should not be harmonised so that trustees are prevented from paying income to non-vulnerable beneficiaries during the lifetime (or relevant period) of the vulnerable beneficiary?

4.11.1 The same considerations apply here as to question 10 (qv). Harmonisation seems appropriate.

Q12. Are any transitional provisions required? If so, what transitional arrangements would respondents suggest?

4.12.1 If the new rules are more restrictive than now, it will be necessary to preserve the status of existing trusts. If an existing qualifying trust were burdened with a higher IT or CGT liability as is suggested by paragraph 7.2, it would deplete the trust assets available to meet the needs of the beneficiary. To avoid this, transitional rules would be needed to preserve the qualifying status of trusts which were set up in good faith for the benefit of vulnerable or disabled beneficiaries, and which cease to qualify not through any alteration in the condition of the beneficiary, but because of a rule change.

4.12.2 Property added to an existing qualifying trust should also be protected by transitional provisions, provided the addition to the trust fund was exclusively for the benefit of the vulnerable beneficiary.

Q13. What adverse impacts on the equality groups do respondents expect? How do respondents suggest any such impacts be mitigated?

4.13.1 Whether there are adverse impacts on equality groups (the obvious group in this context being disabled people) will depend upon how the new legislation is formulated. If entitlement to vulnerable trust treatment is more restrictive under the new rules than now, there will be major adverse impacts on those who need the protection of a trust but will not qualify under the new definition. They will suffer a disadvantage compared with their non-disabled counterparts who can manage their own property and affairs without needing the protection of a trust, and who can therefore be taxed at the rates applicable to them as individuals rather than the higher rates applicable to trusts.

Q14. Do respondents know, or can they estimate, the likely number or proportion of vulnerable beneficiary trusts for severely disabled beneficiaries that currently qualify on the basis of the DLA criteria as opposed to the other two criteria listed at paragraph 2.9?

4.14.1 If any person or organisation had access to this information, it would be HMRC. But we understand from paragraph 8.4 and from our discussions with officials that HMRC do not keep such records.

LITRG

8 November 2012