Chartered Institute of Taxation

30 Monck Street
London SW1P 2AP
T: +44 (0)20 7340 0550
E:post@ciot.org.uk

The Taxation of Trusts: A review

Response by the Chartered Institute of Taxation

1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) presents its response to the HMRC document *The Taxation of Trusts: a Review* ('the Review') issued on 7 November 2018.[1]

1.2 The Review sets out the principles that government believes should underpin the taxation of trusts – transparency, fairness and neutrality, and simplicity. It seeks views and evidence on the extent to which the status quo aligns with these principles, giving examples of areas where government believes the status quo may not meet them fully at present. It also seeks views and evidence on the case for and against reform to these or other areas. At this stage, the government is not making specific proposals and we welcome the fact that this consultation is taking place at stage one of the consultation process.

1.3 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.4 Our stated objectives for the tax system include:

- A legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- Responsive and competent tax administration, with a minimum of bureaucracy.

[1] https://www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review

2 Executive summary

2.1 The four principles set out by government to underpin the taxation of trusts: transparency, fairness, neutrality and simplicity are uncontroversial. In terms of fairness and neutrality, a reasonable starting is that individuals with similar income and assets should pay the same amount in taxes. The corollary is that yield to the Exchequer from taxpayers in similar circumstances should be the same. 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.

2.2 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 suggest that posing the question of what a truly neutral regime would look like (see para 3.3 below) is a useful exercise because it casts light on some of the more detailed issues that arise in considering reform of the current system.

2.3 We suggest that the efficacy of the implementation of the EU's fourth and fifth Anti-Money Laundering Directives (4MLD) (5MLD) in terms of achieving the government's transparency objectives should be evaluated before further measures are introduced. In relation to the implementation of 5MLD, we intend to make a response to the upcoming consultation. For the purposes of this Review, we emphasise the importance of reasonable timescales for compliance, timely and clear guidance (particularly in relation to the definition of 'legitimate interest') and effective online processes.

2.4 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.

2.5 In terms of the use of offshore trusts generally, UK resident and domiciled individual settlors are unlikely to establish non-UK resident trusts because of the adverse tax consequences of doing so, and the cost of establishing and maintaining an offshore structure. As a consequence of the significant anti-avoidance and evasion measures together with AML compliance requirements in the UK, HMRC have access to substantial levels of taxpayer data and therefore, given the breadth of existing measures, the case for further provisions or powers should be evidence-based and targeted.

2.6 Targeted reform to the Inheritance Tax (IHT) regime as it applies to trusts should be considered against the background of the contrast in low yield from lifetime transfers (charges within the relevant property regime in respect of relevant property trusts were £180m in 2017/18) when compared to IHT death transfers of just over £5bn. The level of complexity within the current trusts taxation does not seem justified by this very low yield. We suggest therefore the modelling of alternatives such as the suggestions at Appendix B. Modelling alternatives should address trust taxation in the round, not IHT in isolation.

2.7 It is widely recognised that vulnerable beneficiary trusts, despite reforms, remain complicated. We suggest that consideration should be given to abolishing any special regime for children's trusts (which is only relevant anyway now on death, and settlors in these circumstances already have the option of a qualifying immediate post-death interests (IPDI) at present 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 merged with the taxation of disabled trusts (which cover a very different constituency). This is particularly the case given that the IHT regimes are already fundamentally different.

3 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 system; including views on how to balance fairness with simplicity where the two principles could lead to different outcomes.

3.1 The four principles set out by government are uncontroversial objectives. However, the extent to which they are capable of simultaneous achievement, given that one may counteract with another, is less clear, as the consultation recognises. For example, income of discretionary trusts is taxable on the trustees at the basic rate or dividend ordinary rate within the starting rate band and at the trust rate (currently 45%) or the dividend trust rate (currently 38.1% where income exceeds the starting rate band). If and when the income is paid out to beneficiaries, the beneficiary receives a credit for the trust rate tax. If their personal rate of tax is lower than the trust rate, they are entitled to claim a repayment of the tax. The complex process to adjust the rate of tax suffered to the appropriate rate for the beneficiary could be simplified by applying a lower trust rate to the income of the trust to say 40%, but without a credit for the beneficiary. However, that simplification would operate unfairly for beneficiaries who are only basic rate taxpayers or who pay no tax at all as their income falls below the personal allowance.

3.2 Fairness must always be an elusive concept: from whose viewpoint? A reasonable starting point might be to consider the economic concept of 'horizontal equity', that is individuals with similar income and assets should pay the same amount in taxes. The corollary is that yield to the Exchequer from taxpayers in similar circumstances should be the same.

One of the difficulties in applying this concept to the taxation of trusts 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 a group and when compared to individuals who own assets outright or are entitled to income without limitation.

The Review adopts one approach to fairness based on neutrality in the broad sense that the tax treatment of trusts should neither act as an incentive nor a disincentive to their use. This approach still involves the conceptual challenge that a relevant individual's circumstances are not the same when making a comparison between the individual's circumstances where a trust does or does not exist because the existence of a trust alters the legal and beneficial relationship with the trust assets and income.

3.3 The Review approach raises the question of what a truly neutral regime might look like, a regime 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 could for example (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. Distributions out of discretionary arrangements prior to the settlor's death would then 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 some kind of 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. We refer to this below as the 'hybrid neutral model' (hybrid because it takes a mixed approach as to whether to deem the trust assets or income to belong to the settlor or to the beneficiaries). Such an approach might not necessarily be desirable (because, even in this 'hybrid' version, the deeming provisions it would entail do not fully respect the fact that the legal position of trust-held assets is different from in 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 this degree of true neutrality would entail, particularly when considering such specific issues as the proposed professional services exemption, the interest-in-possession rules; and settlor-interested trusts.

3.4 Simplicity is highly desirable, but we recognise that in practice it is not always easy to achieve. Particularly since the introduction of the 2006 changes, the IHT regime has become far more complex both in terms of structure, and compliance. Given that most of those using express trusts will generally be better off and likely to have advisers in place, we suggest that if there is a trade-off between fairness and simplicity then - in the area of tax at least - a fair but complex measure is to be preferred to a simple but unfair one.

3.5 Stability or consistency of approach should also be factored in, as trusts are long term 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, it would seem to us, as increased costs in reviewing and enforcing compliance for HMRC. This is particularly so in the absence of consultation.

3.6 We think the Review, at 2.4 and 3.4, is right to acknowledge the important place that trusts occupy in the UK legal system. We would identify further examples of the potential value of trusts in the increasingly complex dynamics of the modern family. For example:

- in a second marriage, to provide income for the survivor, and then the capital to the settlor's own children;
- to provide for children and grand-children after the age of 18 (many testators and settlors regard 18 as too young an age at which to have full financial understanding and responsibility);
- to prevent fragmentation of the family company or farm or other business assets;
- to provide for succession for the vulnerable, those who may face declining capacity in their senior years;
- to provide protection for individuals who are vulnerable through exposure to drugs or alcohol abuse or financial immaturity;
- to protect the security of high profile individuals;
- to provide flexible familial lending to adult children as first time buyers;
- asset protection to safeguard assets from potential perceived external risk such as bankruptcy or divorce;
- to enable those who are not happy with forced heirship provisions (typically of other legal systems) applying on death (particularly where there in inequality between sons and daughters) to set up lifetime trusts;
- potentially to provide independent oversight of assets when their owner is in public office

- to prevent lengthy and restrictive probate formalities on death of a testator who owns the assets personally where assets are owned in different jurisdictions. This is particularly problematic where heirs of an estate are scattered through different jurisdictions with different rules about inheritance. Double taxation can result if the deceased is taxed on his death in one country such as the UK and the heir is taxed on inheriting the asset in another eg Ireland. There are few appropriate capital double tax treaties.

3.7 A further benefit of the modern UK trust (to which we consider the Review may not give sufficient weight) is that it enables different beneficiaries to have different interests at different times as well separation of rights over income and assets. This flexibility is a key component in providing for differing (and unknown needs) through generations as the needs of individual family members change. It is recognised that this flexibility, while it has many potential non-tax benefits in a family context, lends itself to potential tax arbitrage leading in turn to anti-avoidance provisions and consequential complexity. Some of our suggestions below deal with this tax arbitrage.

3.8 The Ipsos Survey[2] has a limitation in that the emphasis is on the taxpayer making a trust or doing nothing. In reality the decision would typically lie between making an outright gift and creating a settlement. The reasons for choosing an outright gift in preference to a settlement are not explored.

4 Question 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.

4.1 The online Trust Registration Service (TRS) is part of the implementation of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 to give effect to the EU's fourth Anti-Money Laundering Directive (4MLD) forming part of the UK's wider anti-money laundering and counter-terrorist financing strategy. The short timescale for implementation of the TRS and the processes around registration has given rise to very significant concerns in terms of the amount of work and therefore resource to implement the new requirements with an inevitable increase in costs to professional firms, individual trustees (particularly of small trusts) and to HMRC.

The extension in scope of the registration requirements to all express trusts (not only those with a tax liability and however small) and the potentially broader access to information on beneficial ownership of trusts that will arise as part of the transposition of the fifth Money Laundering Directive (5MLD) into UK law while potentially enhancing transparency causes some tension with the government's wish to facilitate the straightforward usage of trusts where they are the appropriate legal mechanism. This tension can be mitigated to some extent by reasonable timescales for compliance, timely and clear guidance (particularly in relation to the definition of 'legitimate interest') and effective online processes.

As flagged by the House of Commons European Scrutiny Committee in assessing 5MLD[3] the issue of how information is managed and verified for accuracy by HMRC is important and one that needs to be addressed before any further requirements are placed on the regulated sector or other individuals with respect to beneficial ownership information.

[2] https://www.gov.uk/government/publications/exploring-the-use-of-trusts
[3] https://publications.parliament.uk/pa/cm201719/cmselect/cmeuleg/301-xii/30118.htm#_idTextAnchor027

An evaluation of the efficacy of the implementation of 4MLD and 5MLD in terms of achieving the government's transparency objectives, with appropriate weight given to other fundamental rights such as security of data, respect for privacy and family life and proportionality, should be undertaken before taking further measures.

Evidence of a consequential increase in establishing trusts in other jurisdictions that are not subject to UK equivalent levels of AML regulation or professional standards and supervision should form part of this evaluation.

4.2 There is currently a multiplicity of reporting regimes: as well as the TRS the most significant are the CRS and FATCA. The requirements are overlapping and not consistent. There is scope for simplification here to the extent that is within the UK's control. It should be recognised in this context that privacy can be a legitimate objective, and should not be overridden merely for reasons of public curiosity. Families have a right to privacy for security and other reasons, except to the extent that HMRC must have access to the information they need to monitor and intervene appropriately in the tax compliance required, and, except to the extent that it can be shown that public access to the information is, on the evidence, proportionately required to assist in effectively combatting money laundering and similar crimes.

4.3 The costs of complying with the various compliance requirements including TRS registration and maintenance, are significant, and may act as a disincentive to creation of a trust in what would be otherwise appropriate circumstances. This may be a factor in the declining number of trusts revealed in the HMRC statistics published on 14 February 2019. [4]

5 Question 3) The government seeks views and evidence on the benefits and disadvantages of the UK's current approach defining the territorial scope of trusts and any other potential options.

5.1 The current rules for income tax and capital gains tax relation trust residence are relatively straightforward for individual trustees based on their residence status for a particular tax year and the residence and/or domicile status of the settlor.

5.2 In terms of corporate professional trustees there is complexity in the current approach in that the current rules adopt the concept of permanent establishment for determining residence[5]. The professional bodies have worked extensively with HMRC on the guidance in this area to provide clarity for the application of this test but it is still of uncertain application in some cases and means that many professional non-resident trustees will insist on using non-UK agencies for all purposes including investment and accounting. We suggest that the PE test is refined as it is not appropriate for trusts.

5.3 The application of neutrality in the context of the trustee residence rules should allow for professional corporate trustee services to be provided in the UK to offshore trusts without adversely affecting the residence of the trust, in the same way as other advisory, compliance and regulatory services are available to offshore trustees.[6] Using a UK resident professional corporate trustees currently exposes a trust to UK capital

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/778417/Trusts_bulletin_Feb_2019.pdf

[5] TCGA 1992 section 69(2D) and ITA 2007 section 475(6)

The current rules include the provision that 'if at a time a person '(T)' who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the United Kingdom through a branch, agency or a permanent establishment there, then for the purposes of [this section] assume that T is UK resident at that time.

[6] Prior to the 2006 reforms there was a limited professional trustee exemption for capital gains tax purposes however this was not replicated in the current rules

gains tax and income tax at the highest rates even if the beneficiaries and settlor have no connection to the UK.

5.4 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 UK service providers and with the potential for additional tax revenues in the UK based on the profits of the business concerned and the salaries of their employees.

5.5 In addition, allowing non-UK settlors to establish trusts in the UK which are not UK tax resident may 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.

5.6 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. It is worth noting that, 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.

5.7 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 and given the concern about permanent establishment noted above is rarely done, in case the UK resident trustee is treated as agent of the non-resident corporate.

5.8 Modelling alternative residence tests based on the existing approach to taxing trusts should help to identify the scope for simplifying the current test and opportunities for enhancing neutrality. Two possible alternative models are explored at Appendix A

5.9 The alternatives outlined at Appendix A are based on the status quo in terms of the current approach to the taxation of trusts. However, adopting an alternative suggested framework for trust taxation such as the hybrid approach in para 3.3 or other models (under which tax would follow the residence and/or domicile status of the beneficiary or settlor) would obviate the need for a residence test based on trustee status, and would similarly ensure that the provision of UK professional trustee services would be tax neutral.

5.10 In the hypothetical hybrid neutral regime outlined in para 3.3 above, and arguably in any version of a neutral regime, the existence of UK based professional trustees would not bring a trust into, or further into, the tax net.

6 Question 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.

6.1 There are a variety of tax and non-tax factors in the choice of location of trustees and it is worth starting with the non-tax factors before looking at the part which tax plays. These non-tax factors – which usually favour non-UK trustees – include stability of law (that is, it should not constantly chop and change), regulatory standards, active courts, legislatures which modernise trust law (for instance in allowing purpose trusts or foundations); and a professional cadre of trustees who are used to dealing with the complexities of modern, usually internationally mobile, families.

By contrast, while the UK would be well placed with a large professional class of lawyers and accountants capable of acting as trustee, other factors such the UK's tax and regulatory system for trusts and constant changes in the law mean that the UK is not seen as a location in which to base a trust unless there is a need to do so. Given a choice (ignoring tax factors) we would have to say that, in our experience, most settlors would currently choose non-UK trustees.

However, tax considerations cannot be ignored and UK resident and domiciled individual settlors are unlikely to establish offshore trusts because of the adverse tax consequences of doing so (see 6.5 below)

By contrast, non-UK resident settlors will almost certainly never choose UK trustees because of the adverse tax consequences of doing so. (See our comments and suggestions in this regard at 5.4 above)

6.2 Settlors using a non-UK resident trust are likely to fall into two broad categories;

- Non-UK domiciliaries resident in the UK for relatively short term employment, or for business, investment or for long term residency who are using a non- UK resident trust as part of UK tax planning (see paragraph 6.3 below), and;
- Non-UK domiciliary settlors and beneficiaries of international trusts that engage with the UK tax system usually because a beneficiary comes to the UK (see paragraph 6.4 below).

6.3 *Non-UK domiciliaries*

UK and offshore trustees will be liable to IHT on all UK trust assets. However, a trust created by a settlor who is non-UK domiciled has certain specific statutory protections some of which require the trust to be non-UK resident. These protections were introduced as part of the recent reform of the taxation of non-UK domiciliaries in accordance with a clear policy intent.

6.4 *International trusts*

Offshore trusts are an established part of the global financial planning of internationally mobile non–resident non-UK domiciled individuals. Such 'international' trusts are usually created for reasons unconnected with UK tax but instead for the advantages they provide in terms of asset protection, privacy and flexibility in succession. The settlors of such trusts may remain wholly unconnected with the UK. Beneficiaries of such trusts may, however, become resident in the UK for reasons of education, marriage or due to other personal circumstances. The trusts will necessarily be sited I jurisdictions which do not tax the trust itself as the settlor or beneficiaries will pay tax.

6.5 *UK resident and domiciled settlor establishing an offshore trust.*

Settlor-interested trusts

In broad terms, the settlement rules (ITTOIA 2005 Part 5 Chapter 5) attribute offshore trust income and capital gains on an arising basis to a UK resident and UK domiciled settlor who establishes an offshore settlor-interested trust. CGT hold-over relief would not apply to any transfers to the trust leading to potential CGT liabilities when assets are transferred to the trust. There are therefore potentially adverse tax implications where an individual settles cash or assets in an offshore (or an onshore trust) and is capable of benefiting under the trust.

Although the residence status of a trust determines how the trust, the settlor and the beneficiaries are taxed to UK income tax and capital gains tax, it does not directly affect the IHT position of the trust. For offshore trusts, liability to IHT is based on the domicile status of the settlor when the trust is created (or when funds are later added to it) and the location of the trust assets.

All trust assets (wherever situated) of a trust (whether UK or offshore) made by a UK-domiciled settlor are therefore generally within the IHT net. Typically, therefore there does not seem to be any IHT advantage for a UK domiciled settlor to establish an offshore trust.

Non settlor-interested trusts

In terms of non-settlor-interested trusts (where the settlor, spouse or civil partner or unmarried children are excluded from any benefit), trustees of an offshore discretionary trust are liable for income tax in respect of UK-source income (broadly, income arising from UK assets such as dividends where there is any UK resident beneficiary). Trustees are not liable for income tax on foreign-source income. Under the transfer of assets abroad (ToAA) rules, UK resident beneficiaries are taxed when they receive a benefit from an offshore trust.

Trustees of an offshore trust are not liable to CGT on disposals of assets other than UK trading assets and disposals of UK residential property and (from 6 April 2019) disposals of UK non-residential property and shares in property-rich companies (as defined). Capital gains realised by offshore trustees are taxed on UK resident beneficiaries as and when they receive a capital payment (broadly, a benefit) from the trust.[7] However, where the settlor is alive and UK resident and domiciled it is necessary not merely to exclude the settlor and spouse and minor children but also settlor/spouse/all children and grandchildren of any age and their spouses. In practice therefore UK domiciled settlors will not set up offshore trusts as they are almost always taxed on all the gains even if excluded.

Therefore, an offshore discretionary trust appears to have very limited income tax advantages and significant CGT disadvantages over UK resident trusts for UK resident and domiciled settlors.

As above for settlor-interested trusts, all trust assets remain within the IHT net. There is therefore typically little IHT advantage for a UK domiciled settlor in establishing an offshore discretionary trust for IHT purposes.

7 Question 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.

7.1 Measures to tackle offshore tax evasion relevant to the use of offshore trusts include the exchange of information provisions for tax purposes (FATCA, Common Reporting Standards and related inter-governmental agreements), offshore penalties[8], sanctions and criminal offences, disclosure facilities and the requirement to correct past offshore tax non-compliance on or before 30 September 2018, client notification obligations (such as IHTA 1984 section 218 for offshore trusts), information powers (such as ITA 2007 section

[7] Capital gains arising in non-resident companies owned by offshore trustees may also (subject to the availability of a motive defence) be attributed to offshore trustees. (TCGA 1992 section 13).

[8] There are increased minimum penalties where non-compliance involves an offshore matter or an offshore transfer (compared to a domestic tax matter). The penalty % applying depends on what category of overseas territory the offshore non-compliance relates to. Higher risk jurisdictions attract a higher penalty than lower risk jurisdictions. They range from 30% to 200% (depending on the behaviour and before any reductions for quality of disclosure and prompted/unprompted).

748 power to obtain information in relation to the transfer of assets abroad provisions and the TCGA 1992 section 98 power to obtain information for the attribution of chargeable gains from a trust to the settlor) and the trusts register (implementing the EU's fourth Money Laundering Directive, to be substantively extended under the Fifth Money Laundering Directive).

7.2 Anti-avoidance legislation affecting offshore trusts includes the income tax legislation concerning transfers of assets abroad, the income tax and capital gains tax legislation concerning settlements, the trustee borrowing rules and the disguised remuneration provisions (ITEPA 2003 Part 7A). The 2017 reforms to the taxation of non-UK domiciliaries and the FA 2018 anti-avoidance provisions have introduced further complexity for non-UK domiciliaries albeit with statutory protections referred to at 6.3. Any reform of the taxation of offshore trusts should be considered in the context of the non-UK domiciliaries regime as a whole.

7.3 In addition to these tax measures, most UK professional advisers engaged in providing taxation advice in relation to establishing offshore trusts will be subject to the UK's anti-money laundering (AML) regulations[9]. Anyone giving tax advice on trusts is required to report knowledge or suspicion or reasonable grounds for suspicion (unless the privilege reporting exemption applied) where tax evasion is in point or where proceeds of crime are being laundered. An adviser needs to take reasonable steps to satisfy him or herself that the funds in the trust come from a legitimate source and the purpose of the trust is not tax evasion.

7.4 In terms of professional conduct regulation, the Professional Conduct in Relation to Taxation (PCRT) sets out the principles and standards of behaviour that members of certain UK professional bodies (including the CIOT) must follow in their tax work, and specifically includes rules governing conduct in relation to avoidance and evasion. The PCRT was updated with effect from 1 March 2017 in consultation with HMRC and other key stakeholders following the government's challenge to the profession concerning professional conduct rules and tax avoidance around the time of the 2015 Budget.

7.5 However, it is also recognised that trusts may be established by professionals outside the UK (subject to certain reserved activities in the UK) and, depending on the jurisdiction involved, those firms or individuals may not be subject to UK equivalent levels of AML regulation or professional standards and supervision although standards of regulation may be stringent in others such as the Crown Dependencies.

7.6 As a consequence of the measures described at 7.1 above and AML compliance requirements, HMRC have access to substantial levels of taxpayer data, and the challenge may lie in data analytics, and using its results, that is, utilising and analysing the available data rather than introducing new powers. Given the breadth of existing measures, we are sceptical of the need for further provisions unless there is evidence for their need. If there is such evidence, we suggest that any additional measures, unless the nature of the evidence suggests otherwise, should likely be restricted to matters involving those jurisdictions which attract a Category 3 territory classification (those that have not agreed to share any tax information with the UK).[10]

7.7 We feel that it is also worth mentioning that some uses of trusts, portrayed as 'tax avoidance' in the mainstream media, are not tax avoidance at all (in the sense used in the *Willoughby*[11] case): they are simply 'taking advantage of a fiscally attractive opportunity clearly afforded by Parliament'. The use of protected trusts by those coming up to deemed domicile in the UK would be one clear such example. While the media and politicians may portray these as tax avoidance, they are simply the rules as Parliament has enacted – and very clearly intended – to enact them. We fear that other respondents to this Review may mistakenly

[9] The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692)

[10] Category 3 territories have not agreed to share any tax information with the UK. The offshore penalty regime already recognises the seriousness of non-compliance using Category 3 territories by applying higher penalties where these territories are involved

[11] [1997] 1 WLR 1071

categorise the use of trusts as avoidance, and hope that HMRC will make the distinction clear when publishing its response.

8 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.

8.1 Before looking at the possibilities for reform of the IHT regime for trusts, we suggest that a wider question might be asked: does the yield from IHT justify the complexities of the current IHT regime?

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. Charges within the relevant property regime in respect of relevant property trusts 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 ten 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 within the trusts regime which currently exists does not seem justified by this very low yield.

Given that death is uncertain and the existence of the seven year rule on lifetime gifts there is an inherent difficulty in trying to achieve neutrality between that regime in the non-trust scenario, and a regime in which there are predictable charges at predictable dates, even if in theory these charges are very significant (as, for example, the charge on the initial transfer certainly is). Theoretically, one response to this might be to make the regime ever more draconian, but the result of this would likely be, not more revenue, but trusts not being established at all, for fear of the tax consequences – and in that scenario, the non-tax benefits of the trust structure are in effect lost. Arguably this is happening to some degree with the current regime, as it would seem to be comparatively rare that such a trust is established other than with the effective shelter of the Nil rate band – as evidenced by the low tax take. We have tried to reflect on this dilemma in developing alternative suggestions.

Given that it might reasonably be assumed that both adviser and HMRC administrative time taken in dealing with trusts is considerably greater than the 3% or 4% and significant wealth is held within trusts, it seems timely to consider an alternative framework in line with the remit of the Review. We therefore put forward for consideration a comprehensive package of measures in Appendix B. These suggestions address trust taxation in the round, and consider the interaction of income tax and CGT, as well as IHT. We believe that looking at IHT in isolation would not be appropriate.

The rest of this section looks at more limited reforms to the IHT regime for trusts.

8.2 The treatment of trusts as taxable in their own right can never result in true neutrality at the level of particular taxpayers. It might be hoped that it could produce an approximate balance of tax revenue collected in aggregate from the trust as compared to the non-trust regimes. However, the revenue yields call into question whether even this is a realistic hope, given that the regime might already be viewed as a tough one on paper. For example, the changes introduced by Finance Act 2006 effectively mean that all lifetime trusts in excess of the settlor's nil rate band face a 20% IHT entry charge, a 6% ten-yearly charge, and exit charges thereafter. That compares with no tax on an outright gift to an individual (a Potentially Exempt Transfer 'PET'), where the donor survives seven years (see further discussion at 8.4 below)

8.3 Paragraph 5.3 of the Review correctly states that the options for taxation include:

(1) treating the assets as still owned by the settlor while alive;

(2) owned by beneficiaries (perhaps not possible in any fair way when the beneficiaries may be unascertained and unascertainable); and

(3) treating the trust as a taxable entity in itself, as happens currently. (This approach does not preclude also taxing beneficiaries when benefits are provided with the beneficiary receiving a tax credit for tax paid by the trust - as largely currently applies to income arising to non-settlor interested trusts. Any distribution to a particular taxpayer will almost certainly give rise to a tax event reflecting the particular circumstances of the beneficiary, giving rise to some inevitable complexity.)

The model set out at para 3.3 above might be viewed as a hybrid of (1) and (2), treating beneficiaries who are beneficially entitled to assets/income as taxable as if they own or are entitled to the income outright, and treating settlors as still owning assets/income that are subject to trustees' discretion. Arguably the impact of the deeming provisions under this model – although still significant in many scenarios - are much less of a stretch from legal reality than is the case with models 1 or 2 above.

Although each alternative will involve drawbacks and hurdles to neutrality (as with the current regime), modelling the different approaches is a useful exercise because it casts light on where the challenges lie in achieving neutrality of treatment of treatment of similar individuals and therefore Exchequer yield.

8.4 Since Finance Act 2006 most lifetime trusts are within the relevant property regime with the result that such trusts are subject to the lifetime entry charge (20%), ten-yearly charges while the trust exists, and exit charges when trust property ceases to be relevant property. There are only four categories of interests in possession where, instead, lifetime IIP trust property is taxed for IHT purposes as if it belonged outright to the beneficiary. including (most commonly) an interest in possession which is an immediate post-death interest (IPDI), or an existing interest in possession to which the individual has been beneficially entitled since before 22 March 2006. Yet arguably this is the most neutral treatment and is what would happen with all 'interest in possession' cases under the 'hybrid neutral' model - and under any model in which assets or income were ascribed to the beneficiary. (Strictly, the IIP regime ascribes ownership of assets to individuals entitled to the income arising from them, that is to say entitlement of income (not assets) drives deemed ownership of assets. This rule can be viewed in part at least as an anti-avoidance measure, protecting the revenue from people exploiting the legal possibility within a trust of separating ownership of assets from income as a basis for tax avoidance: if so, this revenue protection is achieved in a commendably simple and understandable way.)

In our view, in an IHT context, the true comparator for an interest in possession trust is an outright lifetime gift because the settlor has divested him or herself of the asset. Neutrality could be achieved therefore by reverting to the QIIP regime, whereby a beneficiary having a right to income is treated as beneficially owning the underlying capital (akin to the hybrid at paragraph 3.3 above). It is inconsistent to have that regime applying to trusts created on death, but not currently during life. A concomitant advantage would lie in reduced compliance costs (for taxpayers and HMRC) by not having to calculate the complex charges of the relevant property regime.

8.5 It is arguable whether or not the relevant property regime is 'fair'. It is commonly suggested that the rationale for the 20% entry charge plus 6% each tenth year, which totals 40% over a 33-year period (equivalent to a generation), is equivalent to 40%, thereafter the decennial charges over a generation broadly match the 20% lifetime charge. However, that broad numerical equivalence ignores other factors such as, on the one hand, the collection of tax at an earlier stage, so the effective charge may well be greater. On the other hand, the lifetime charges, unlike at death, arise in a manageable timescale, facilitating planning which may legitimately lead to an overall lower tax cost. Where such planning would not be effective (eg because the assets significantly exceed the nil rate band, the impact may be that people are deterred from using the trust route at all.)

8.6 Currently, a person who wishes to use a trust to self-settle assets to protect against, for example, the vulnerabilities of age, faces adverse tax charges in doing so. Broadly, such a trust would currently be settlor-interested for income tax purposes – which is neutral, but at a compliance cost, but be taxed as a trust for CGT purposes (reduced annual exemption and higher CGT rates). For IHT however such a trust would fall into the relevant property regime and also remain, as a gift with reservation of benefit, taxable within the settlor's own estate. Amending the regimes for CGT and IHT in these circumstances so that complete 'see-through' transparency is achieved and the trust's gains and capital remain taxed on the individual settlor offers potential benefits in terms of the principles of fairness, neutrality and above all, simplicity. Appendix B explores these themes.

8.7 Prior to the FA 2006 reforms, accumulation and maintenance trusts, the purpose of which was to make discretionary provision for persons up to the age of 25, were not included within the relevant property regime in the period before beneficiaries became entitled to income or capital. This IHT treatment was withdrawn in FA 2006 and 18-25 trusts and trusts for bereaved minors were introduced as a partial replacement, applicable only on death of a parent. These regimes are an unnecessary complication; the charge at 25 in particular provides a trap for the unwary (whilst, as we have seen, not raising a great deal of revenue in aggregate), and pre-empts the ability to make staggered provision at different ages beyond 25, which might be desirable for non-tax reasons. A modified version of the accumulation and maintenance trusts regime could simplify the current complex rules which impose unnecessary distinctions (and tax consequences) between settlements for children that depend on age of entitlement, identity of the child (own or grandchild), and whether created during life or on death.

Alternatively allowing individuals to establish qualifying QIIP trusts during their lifetime would facilitate provision for children and grandchildren in that way.

8.8 The exemptions from the IHT regime for employee trusts established for commercial objectives reflect the policy intent to recruit, retain, motivate and reward employees or to maintain the independence and ownership of the sponsoring company or secure its succession from existing owners to the employees as a whole. Some recognition of this in the trust regime rules is therefore appropriate, and we recognise also that the rules need to address the potential for tax avoidance. That said, the legislation ensuring that employee trusts funded by close companies are not used to avoid tax (eg IHTA section 13) can operate incoherently, for example, a 5% participant would be prohibited from acquiring shares under an employee share option at an undervalue from the trust, although they would be fully liable to income tax on the undervalue. Alternatively, in this close company scenario the shareholders (for example, the employee trusts and individual employee shareholders) could suffer IHT liabilities, where there is a close company even though any gratuitous intent is caught by employment tax legislation. Simplification could be achieved by removing employee trusts used for 'approved' purposes (eg employee ownership trusts, trusts for Share Incentive Plans, etc) from the IHT regime entirely and instead utilising the more appropriate income tax, national insurance and PAYE regimes to govern their use.

8.9 The uncertainties about whether other commercial trusts are within the IHT regime should also be resolved. Trusts can play an important part in commercial life – for instance trusts in the travel industry (to ensure that holiday-makers get their money back if the tour operator becomes insolvent) play a very important role. We cannot see a particular policy reason why commercial trusts like this should be within the IHT regime which is an unnecessary complication. HMRC's unwillingness to engage on this issue (seemingly for fear of upsetting the employment-tax issue around EBTs) should be addressed.

9 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.

9.1 The Review paragraph 5.6.1 example of a trust property gaining private residence exemption on account of occupation by a beneficiary and the proceeds then being applied to someone other than the occupier suggest that this position is not neutral when compared to an individual owning and occupying their residence personally and benefiting from main residence relief. The paragraph explains that the non-neutral feature is the fact that the proceeds from the disposal of a dwelling might be applied for the benefit of a non-occupying beneficiary or settlor. However, proceeds from the sale of a main residence by an individual might equally be applied for the benefit of a non-occupier such that an individual would be in exactly the same position in relation to giving away the sale proceeds (at least if the owner survives seven years). The trust relief does not appear simply on the basis of this feature to offend against the principles of fairness and neutrality.

9.2 The Review suggests at paragraph 5.6.2 that a deduction for trust management expenses is essentially a tax subsidy for trusts on the basis that comparable costs are not deductible for individuals. We accept that to the extent this is achieved it would be a factor making for lower tax than in the non-trust scenario, all other things being equal or balancing out. On the other hand, given the additional compliance costs that trusts face (particularly in relation to transparency issues) relief for trust management expenses could be viewed as an example of fairness and neutrality being applied in practical terms. Another aspect, that reflects the difficulty of a neutral comparison, is that beneficiaries have no control over the expenses incurred, as these are an inherent consequence of the trustees exercising their fiduciary duties. Perhaps the fairest thing to say is that the existence of trust management expenses is a feature of the legal differences between the trust and non-trust scenario which limit the ability to apply the neutrality concept sensibly.

9.3 The Review indicates that the classification of income and capital receipts in trust law leads to a non-neutral tax result because of the opportunity to dispute the classification leading to potentially lower tax rates that is not available in a non-trust situation. We note that paragraph 5.6.3 refers to capital receipts being taxed at the basic rate of income tax or at CGT rates, both significantly lower than the trust rate and higher CGT rate for individuals. In fact, as far as we are aware all capital receipts such as buy back of shares or transactions in land are now taxed at 38.1% or 45% (see ITA 2007 section 482) including those of trusts with an interest in possession. Another example of lack of neutrality, but one that increases the tax costs of the trust regime, is found when comparing a discretionary trust's standard rate band of £1,000 with the ISA, dividend and savings income allowances available to an individual. We can see obvious reasons why they cannot simply be made available to trusts as if they were individuals, but this issue does bring out that once one has decided on a separate trust regime, it is in fact quite difficult to achieve true neutrality or indeed, to an extent, identify conceptually what that would be. We are not sure if there is any evidence from overall levels of tax take on savings income and related capital items in the trust and non-trust situations that bears on the issue?

9.4 A further area that leads to an anomalous result is where an non-UK resident trust with UK beneficiaries receives UK source income. ITA 2007 section 812 prevents section 811 (limit on liability to income tax of non-UK residents) applying and therefore the trustees have a UK tax liability. If a beneficiary is subsequently taxed on effectively the same income under the transfer of assets abroad provisions this can lead to an effective tax rate above 60% (61.68% in the case of dividend income). ESC B18 does not always help the position. While there are ways to plan around this (for instance by giving a beneficiary a temporary life interest) these do not work well where a receipt is capital as a matter of trust law but income as a matter of tax law – for instance a share buy-back by a UK company.

9.5 Paragraph 5.6.4 of the Review considers trusts and transactions declared void by the courts[12]. If the court sets something aside for mistake such that the transactions set aside are 'voidable', that is treated as never having happened, it seems wholly appropriate that the tax position should follow the event. There are significant checks and balances inherent in the proceedings; HMRC have the right to be notified and heard, the burden of proof on mistake is quite high and trustees do not make such an application lightly.[13] Moreover, the courts have said that they will not act to countenance tax avoidance or set aside mistakes arising from tax avoidance, see Lord Walker's comments in *Futter*. We accept of course that the existence of trustees' obligations may mean that the scope for transactions to be voided – which can have an adverse revenue consequence – may well be greater than anything in a comparable non-trust scenario – but again, what this tells us is surely that this is an area where things are driven by the legal differences between the trust and the non-trust scenario which makes the neutrality concept difficult to apply.

10 Question 8 - The government seeks views and evidence on options for the simplification of Vulnerable Beneficiary Trusts, including their interaction with '18 to 25' trusts.

10.1 It is widely recognised that vulnerable beneficiary trusts, despite reforms, remain complicated.

We would suggest consideration should be given to abolishing any special tax regime for children's trusts which is only relevant anyway now on death. Settlors in these circumstances already have the option of a qualifying IPDI at present for such trusts.

It would also make tailored and specific reform for disabled trusts much easier if the taxation of trusts for children under 25 is not merged with the taxation of disabled trusts which cover a very different constituency. This is particularly the case given that the IHT regimes are already fundamentally different. Our comments

[12] *Pitt and another v Holt and another; Futter and another v Futter and others* [2013] UKSC 26

[13] Per Lord Walker at [69]: It is a striking feature of the development of the *Hastings-Bass* rule that it has led to trustees asserting and relying on their own failings, or those of their advisers, in seeking the assistance of the court. This was pointed out in no uncertain terms by Norris J in his first instance judgment in *Futter*, quoted at [3], above. There may be cases in which there is for practical purposes no other suitable person to bring the matter before the court, but I agree with Lloyd LJ's observation (at [130]) that in general it would be inappropriate for trustees to take the initiative in commencing proceedings of this nature. They should not regard them as uncontroversial proceedings in which they can confidently expect to recover their costs out of the trust fund.

below therefore are only in respect of disabled trusts (and we do not cover here whether the definition of disabled should be extended).

10.2 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. [14] By way of example only, the capital disregards in respect of a disabled person's interest which is an actual interest in possession for a disabled beneficiary as opposed to a deemed interest in possession (ie an interest in possession falling within s89B(1)(c)) have different commencement rules. [15] The aim of the special income tax treatment[16] 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. It could then be put down on his tax return and no trust return would be needed at all. The complicated pooling provisions for trusts would not apply.

10.3 Payments to or for his or her benefit would be ignored for tax purposes as the gains and income would already have been taxed by reference to the beneficiary's personal rates. On death of the disabled beneficiary there would be a CGT uplift as if he owned the assets personally and IHT would be payable on death. There would be no ability to benefit anyone other than the disabled beneficiary while he is alive except to the extent that this payment benefits the disabled beneficiary (and of course such a payment would not be a PET).

10.4 The trustees would be responsible for accounting for the tax on income and gains (as the trust income and gains would not necessarily be distributed to the beneficiary each year) and would pay the tax due 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 are far more onerous and in practice limiting this tax regime to disabled beneficiaries rather than children under 25 targets the correct people.

10.5 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 will be able to submit tax returns on behalf of that beneficiary showing the total income and gains including trust income and gains.

10.6 Existing disabled trusts would be taxed under current rules although if their terms were amended to comply with new rules (eg 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.

10.7 Simple precedent forms would be available online for disabled families to use in the same way as when registering charities. Australia has a regime similar to a transparent one 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

[14] 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.

[15] FA 2013 Sch 44 para 10(5).

[16] And CGT: see FA 2005 ss.26–32.

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 that appropriate for disabled persons.

11 Question 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

11.1 Given the complexity (and therefore the costs involved in preparing a relevant property trust IHT calculation particularly for many small trusts) we suggest exploring the possibility that trustees be given an option, where chargeable trust assets are under a certain value to pay (based on broad revenue neutrality), say, for the purposes of illustration, 3% of the value at the ten year or exit point rather than complete full IHT100 returns. In putting this forward we recognise, of course, the difficulty in characterising a parallel elective regime as a simplification.

11.2 Appendix B suggests a wider model for reform of trust taxation generally, bringing together a number of the themes discussed earlier.

11.3 The decision in *Crowe v Appleby*[17] held in broad terms that where individuals become successively entitled to an absolute interest in English land, they do not together become absolutely entitled as against the trustees for CGT purposes until the last of them become so entitled, typically upon attaining an age. Therefore, there is no deemed disposal and reacquisition within TCGA 1992, section 71 until the beneficiaries as a whole are absolutely entitled. Consequently, if a beneficiary should die over the age of entitlement, but at least one other beneficiary is under the age of entitlement, there will be an IHT charge under general principles but, because there is not a qualifying interest in possession for CGT purposes, there will be no CGT-free uplift to market value at that point. We believe that it is anomalous that a CGT-uplift is not available in these circumstances despite there being an IHT charge, when in a comparable non-trust situation the CGT-uplift would arise.

11.4 The Review overlooks the use of trusts in commercial and employment contexts (see also 8.9 above). The complexities of flat management companies holding service charges for future contingencies and repairs could be simplified if they were to be treated as bare trusts, and the Landlord and Tenant Acts revised to deal with the position of service charges held for the lessee of a forfeited lease (the current provisions make such funds relevant property for IHT). Appendix C reviews the position of employment trusts.

11.5 The current settlor- interested regime gives rise to complexities that are disproportionate to the revenue raised and a corresponding onerous compliance burden where the trust rate exceeds the settlor's tax rate. The alternative model at Appendix B addresses this issue.

12 Acknowledgement of submission

12.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

[17] 1975] STC 502

13 The Chartered Institute of Taxation

13.1 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 our 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. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,500 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation

7 March 2019

APPENDIX A: Trustee Residence – possible alternative models

One alternative might work as follows:

- 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.
- 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.

Note: 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.

APPENDIX B: An alternative framework for trust taxation.

These suggestions are submitted on the basis of simplicity and neutrality (acknowledging some of the difficulties of applying the neutrality principles fully to the different legal facts, entitlements and obligations in trust versus non-trust scenarios).

Interest in possession trusts (background)

There are currently four categories of qualifying interest in possession ('QIIP') trusts:

- Trusts set up before 22 March 2006 where an individual has an interest in possession ('IIP')- 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 – these can 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

A key benefit of the QIIP 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 QIIP trust during their lifetime other than to a disabled beneficiary. Rather, any such trust is a 'relevant property trust' and will suffer the 20% entry charge. There is therefore a clear difference in treatment between lifetime trusts where generally a qualifying IIP cannot be established and a trust established on death where one can be established. (This seems hard to defend logically given that in the non-trust scenario lifetime gifts are typically treated more, rather than less, favourably than bequests on death in that potentially they may not be taxed at all.) It can also facilitate tax arbitrage, as IIPs within a relevant property trust can be chopped and changed for income tax and CGT planning purposes without any IHT consequences – the anti-avoidance aspect of the QIIP regime was noted in para 8.4 of the main paper. This would not be possible if all trusts where an individual took a right to the income were treated as qualifying IIPs for IHTA section 49 purposes. Ending the IIP would then have IHT consequences.

Allowing individuals to establish QIIP trusts during their lifetime would not only be fairer/more neutral and cut tax arbitrage; it would also be an enormous simplification for taxpayers across a range of financial circumstances. We believe it is likely that many (if not most) of the trusts which are currently established as relevant property trusts would instead be established as IIP trusts which, from an IHT point of view, would be much simpler to administer both for taxpayers and for HMRC. In principle HMRC would miss out on the 20% initial charge but the tax take statistics referred to in the main paper suggest that this effect may in practice be limited, presumably given that the seeding of many such trusts which are created is effectively sheltered by the nil rate band.

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 provided the gift into trust is for IHT purposes treated as a gift to the donee.

Due to the 20% entry charge for relevant property trusts in excess of the nil rate band, some 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 however have a number of problems when compared with trusts including, potentially, loss of tax to the Exchequer.

Simplification of the relevant property regime

Much of the complexity of the relevant property regime arises from linking exit charges to the rate payable when there was last a ten-year charge, but this is done by postulating an imaginary chargeable transfer by an imaginary individual. This theoretical calculation seems to have been designed, as a means of aggregating the assets of the trust being charged with the assets of other trusts created by the same settlor on the same day. The changes introduced by Finance (No 2) Act 2015 have compounded the difficulties by also aggregating trusts to which 'same day transfers' have been made. It is the nil rate band calculation that causes the complexity.

Finance (No 2) Act 2015 has, at least, removed the previous requirement to bring into account assets in the same trust which were not relevant property, but a settlor's history of earlier chargeable transfers still has to be counted in on every ten-year anniversary, for the lifetime of the trust.

Nor have the rules been updated to reflect the fact that, since 1988 (thirty years ago) there has been only one lifetime rate of inheritance tax on chargeable transfers. IHTA section 66(1) still refers to three tenths of the lifetime rate. Since 1988 the result has worked out as 6% and it would be more straightforward if the rules were based on a single rate. This observation is the basis for the following proposals for a simplified regime.

- On ten-yearly charges, a flat rate of 6% would apply on the value of the trust above the basic IHT threshold (£325,000).
- To prevent settlors taking advantage by the creation of multiple trusts, that threshold would be divided among all relevant property trusts created by any individual settlor after the date the new rules come into effect (we have in mind a system similar to that for the reduced CGT annual allowance for trustees, so saving the need to delve back into historical records).
- On exit charges, a rate of n/40ths of the flat rate of 6% would apply, according to the expired quarters since the last ten-year anniversary date (or since creation of the trust). This could be simplified still further to x/10ths according to the number of 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).

All the other rules aggregating the history of lifetime transfers and other assets settled on the same day would be removed.

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

Transitional provisions for existing trusts would need to be considered.

Settlor interested trusts

It should be possible for an UK resident and domiciled individual wherever domiciled to create (during lifetime) a settlor interested UK settlement (whether discretionary or an IIP) which would be a look through for all tax purposes (that is the settlor is still treated as owning the assets). This would be a regime similar to that of the US grantor trust and it should be noted that other jurisdictions such as Switzerland 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 also reduce avoidance by reducing arbitrage between jurisdictions.

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.

As the settlor would be taxable on all trust income and gains as they arise whether or not he actually receives them, there would be no need for the current rules regarding capital sums and loans. In any event the capital sums provisions in ITTOIA 2005 section 633 do not appear to achieve anything, except extraordinary and completely unnecessary complexity, given that trust rates can sometimes be higher than settlor tax rates. In addition, our experience is that the compliance aspects of these provisions are poorly understood by HMRC. Abolition of these provisions would greatly simplify the code, we suspect at no revenue cost at all.

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.

The trustees would be obliged to provide the settlor with full details of the gross 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.

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.

We note that such a trust regime could be seen as allowing settlors to elect in, in a defined set of circumstances, to a neutral regime either of the ‘hybrid’ sort noted in 3.3 above or in the version that all assets were deemed to still belong to the settlor. The defined set of circumstances, where the settlor retains an interest in the trust, being those where the violence done to the different legal position of the trust and non-trust scenarios can be viewed as being at a minimum.

It is possible that this would allow settlors interested in the non-tax benefits of a trust scenario, to establish a trust (which currently they would not do because of the initial and other tax costs of doing so) and do so in a way which would lead ultimately to higher tax receipts than alternative arrangements they might make.

Existing settlor interested trusts would continue to be taxed under the current regime.

Inheritance tax

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 IHTA 1984 section18 exemption if a spouse or civil partner has a subsequent IIP interest).
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 (eg children or spouse/civil partner) take an IIP, then this would be a qualifying IIP for IHT purposes, otherwise it would enter the relevant property regime.
e) If the settlor’s interest is terminated during the settlor's lifetime eg the settlor and spouse/civil partner are excluded from benefit, then this would be a disposal for CGT purposes and a transfer of value for IHT purposes (chargeable as a PET or immediately chargeable transfer depending on the nature of any ongoing trusts or if the assets pass outright to a beneficiary).

Income tax

a) The settlor would report and be taxable on the gross 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 as far as the settlor's tax liability is concerned.
c) The trustees would not be subject to income tax on trust income whether or not it is distributed. The trustees would not submit a tax return but would report the level of income to the settlor with copy to HMRC.
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 eg restriction of personal allowances.
e) 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/or 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.

Capital gains tax

a) There would be no capital gains tax 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 capital gains tax rates with the benefit of his annual exemption. If he had created two trusts, then the gains realised for those two trusts would simply be reported on the settlor's tax return and the trustees would file no return. The trustees would report the gains/losses to the settlor with a copy to HMRC. The trustees would not be taxable on the gains during the settlor's lifetime.
c) 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.
d) 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.
e) On the settlor's death the trust assets would benefit from a CGT free uplift as if he still owned the assets outright.
f) If the settlor's interest came to an end during the settlor's lifetime (ie the settlor and spouse/civil partner is 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.
g) 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.

IIP trusts (which are not settlor interested)

IHT transparency

a) Consideration could be given to restoring the IHT position for IIP trusts more generally to make all IIPs 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.

b) 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.
c) There would be no change to the taxation of such trusts other than for IHT purposes.
d) 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.

Inheritance tax

a) If the position is restored as suggested above, a gift to a lifetime 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 on a qualifying IIP trust to avoid reservation of benefit issues.
d) On the life tenant’s death IHT would be levied on the same basis as if the life tenant owned the trust assets outright with the possibility of the IHTA 1984 section 18 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 all 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 exit charge.

Capital gains tax

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 ie much as at present.
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).

APPENDIX C: An overview of the taxation of trusts in the employment context

Employment trusts include employee benefit trusts (EBTs), employee ownership trusts (EOTs), trusts for share schemes (effectively a sub-set of EBTs) and pension trusts (including employer-finance retirement benefit schemes (EFRBS)). Apart from a brief mention at paragraph 3.4.4 of the Review the commercial use of trusts, principally by companies, has not been considered. Offshore professional trustees are commonly engaged for employment-related trusts for the practical reason that there seem to be relatively few UK resident professional trustees dealing with this aspect of the commercial use of trusts and typically larger teams of professional trustees, which can prove cost-effective to larger UK businesses in particular, are found in jurisdictions outside the UK.

Employee trusts play a role in recruiting, retaining, motivating and rewarding UK resident employees. More consideration is needed regarding the role that employee trusts play in incentivising employees/focusing their efforts to achieve enhanced success for a business – in particularly trusts associated with 'approved' share plans or where amounts are otherwise set aside, ring-fenced from creditors, to be distributed to employees as/when targets are met (and of course in the latter case in accord with the permitted exceptions within the disguised remuneration rules). A trust may be used to facilitate the holding of shares for employees to enable or encourage employee ownership, particularly those established:

- for Share Incentive Plans (SIP) pursuant to Chapter 6 of Part 7 and Schedule 2 Income Tax (Earnings and Pensions) Act 2003; and
- for Employee Ownership Trusts (EOT) in compliance with section 236H -236U Taxation of Capital Gains Act 1992;

Any review should take account the employee ownership model documentation first published by the Department for Business, Energy & Industrial Strategy (BEIS) in 2013[18] following the 2012 Nuttall Review[19].

Examples of legislation directed to the encouragement/use of EBTs include:

- trusts used in conjunction with tax privileged employee share plans (eg SIPS – see Part 9 of Schedule 2 to ITEPA),
- the FA 2014 CGT rules on EOTs at S236H-U TCGA 1992,
- the parallel income tax exemption in Chapter 10A of Part 4 of ITEPA for qualifying bonus payments relating thereto,
- s.86 IHTA (trusts for benefit of employees),
- s.239 TCGA (disposals to trustees of employee trusts) and
- the (albeit limited) exceptions from the disguised remuneration legislation for deferred remuneration (s.554H) and shares (s.554I-M).

For employee trusts, it is relatively straightforward to identify the settlor and beneficiaries at any given time, but there could be hundreds, if not thousands, of beneficiaries or potential beneficiaries and the class of beneficiaries will change regularly with employees leaving or joining. Transparency should not therefore be difficult to achieve but the administrative burden is significant for companies linked to such trusts. The government might wish to consider separate tax treatment of trusts established for employees and/or with corporate settlors with a more practical approach to taxation and a simplified tax return, perhaps linked to the employment related securities (ERS) returns companies are required to submit for many of the arrangements involving employee trusts. This could be where there

[18] https://www.gov.uk/government/publications/employee-ownership-company-model-documentation
[19] https://www.gov.uk/government/publications/nuttall-review-of-employee-ownership

are no interests in possession or fixed interests for individual employees or where it meets the statutory qualifying requirements.

It is noted that whilst some employee trusts will have non-UK trustees, others will not or will not be permitted to have non-UK resident trustees (eg SIPs). We illustrate below two of the reasons why employee ownership or other trusts (other than SIPs where it is not permitted by legislation) choose to have a non-UK resident trustee.

First, where trusts are being used to create an internal market for shares or where there are significant numbers of leavers and joiners receiving share awards, the disposals of shares by the trustee can give rise to capital gains that are chargeable. Where there is an outright gift to an employee, who is fully subject to employment taxes on the value, there is a balance relief for capital gains tax for the trustee. Where, however, there is a full or partial payment for the shares, for example on the exercise of a qualifying Enterprise Management Incentive (EMI) share option, or the employee happens to be connected to a participator there is no relief giving double taxation for the employee and trustee on the same value. Where employee trusts have little or no income and are merely facilitating the transfer of shares and are essentially not making cash profits, there is no funding available to meet such capital gains tax liabilities. Therefore, by ensuring the trustees are non-UK resident and not managed from the UK, the administrative and cost burden of these transfers (other than stamp duty) will be eliminated.

Second, as mentioned previously, there are relatively few UK based teams of professional trustees who have experience and operate for reasonable fees. Most of the main banks stopped taking on this business many years ago. It is relatively common for companies to establish an in-house trustee company [eg 'any company name trustees limited'] which can be inexpensive to run, but does require some knowledge of the responsibilities and obligations of trustees, and many directors and employees are unwilling or unable to find the time to take on these onerous responsibilities. Trustees in offshore jurisdictions seem to be able to be more competitive in price terms, perhaps because they work in larger teams and have the critical mass of like work to make it very efficient and focused, and yet are highly regulated and experienced (particularly Jersey and Guernsey). It is therefore tempting for UK businesses to outsource the administration and trusteeship to a more cost effective jurisdiction.

The CIOT responded[20] in 2014 to the new employee shareholding vehicle consultation. We identified the tax obstacles to using EBTs for share ownership and proposed some relaxations to existing rules subject to safeguards. Although the government decided not to proceed with the proposal for a new vehicle (which originated from an OTS suggestion), it did say it could in the future look at the CGT provisions for EBTs. As far as we are aware, this has not happened. As CGT issues were identified as one of the main reasons for establishing EBTs offshore (see paragraphs 1.8-1.11 of the summary of responses) the government may want to revisit the idea of reviewing the CGT provisions for UK resident EBTs from a neutrality perspective.

We believe that successive anti-avoidance measures in recent years have had the result that EBTs effectively function in accordance with government's objectives.

[20] https://www.tax.org.uk/policy-technical/submissions/new-employee-shareholding-vehicle-ciot-comments