



Law Society
of Scotland

Consultation Response

The Taxation of Trusts: a review

February 2019



Introduction

The Law Society of Scotland is the professional body for over 11,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

Our Tax Law, Trust and Succession Law and Mental Health and Disability sub-committees welcome the opportunity to consider and respond to HMRC's consultation: *The Taxation of Trusts: a review*¹. We have the following comments to put forward for consideration.

General comments

We are pleased to note the recognition within the consultation paper of the particular Scottish aspects of trust law. It is important to recognise that in Scotland, trustees are owners of assets within the trust and beneficiaries have rights against the trustees as owners. This differs from the 'beneficial ownership' position in England and Wales.

We note that the consultation paper covers both high level principles of taxation as well as detailed matters, including private residence relief from capital gains tax, trust management expenses, vulnerable beneficiary trusts. We recognise that the distinction between ownership of assets and the benefits arising from them should not prevent HMRC from assessing the tax liabilities of relevant parties. Reforms to the law in this field have prevented trusts being utilised as a way to avoid or evade tax. Generally, the use of trusts add an additional layer of complication to transactions and in some cases, gives rise to additional taxation. We stress as a general point that in the vast majority of cases, trusts are used not as a means to avoid or reduce tax but to protect assets for and in some cases from the beneficiaries of the trust.

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

Consultation questions

1) The government seeks views on whether the principles of transparency, fairness and neutrality, and simplicity constitute a reasonable approach to ensure an effective trust taxation system; including views on how to balance fairness with simplicity where the two principles could lead to different outcomes.

We consider that all principles require to be carefully balanced within the trust taxation system. Although fairness and simplicity are referred to as potentially giving rise to different outcomes, we consider that the balance of all principles could give rise to different and/or conflicting outcomes, not only fairness and simplicity.

We consider that the income tax position of a trust where one or more beneficiaries has a right to the income should be the same as an individual taxpayer. This is the current position in relation to tax treatment. The trust should pay income tax at the basic rate only and once the beneficiary gets the income, they may then have more tax to pay or may get a repayment of tax depending on their circumstances.

We note that a trust is treated as a separate legal person from the settlor, trustees, and beneficiaries. It is interesting to compare the tax treatment of trusts against companies. Trusts and companies are the two most common taxable structures in the UK. In general terms, a company pays tax at a low rate on its income and gains but when assets or income are distributed to shareholders those shareholders will normally pay tax at a higher rate. This can be contrasted with trusts which, unless there is a beneficiary with a right to income, pay tax at the highest personal rate leaving beneficiaries who receive income payments and pay tax at a lower rate (which many will) having to claim a tax repayment. One suggestion may be that trusts be taxed at the basic rate of income tax only, distributions to beneficiaries carry a basic rate tax credit and most beneficiaries will not then have to submit a further tax return or repayment claim.

In general, it would contribute to the fairness, transparency and neutrality if in as many cases as possible only beneficiaries suffered income tax on the income received from a trust, with mechanisms improved to minimise the need for additional trust tax compliance in such cases.

The position is necessarily different in relation to capital taxes, where it is almost inevitable that a trust will be treated in many ways as if a separate taxable person, both as compared to the settlor and the beneficiaries.

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.

The desired objectives of the Trust Registration Service (TRS) are not clear and therefore we are unable to comment as to whether the TRS is meeting its objectives. A number of our members report difficulties with the implementation of TRS and note the unnecessary volume of work which it has created for trustees and

advisers. Some of the information requested for TRS1 was difficult to ascertain and/or of little value to the present situation of the trust.

The TRS only extends to the initial settlement into a trust. It is crucial that a cohesive approach is taken to trust transparency alongside the UK People with Significant Control Register and the Scottish Register of Persons Holding a Controlled Interest in Land.

In relation to the holding of an accurate and up-to-date record of the 'beneficial owner' of the assets in a trust, it must be noted that in proper discretionary trusts, the owners are the trustees. Unless trust transparency goes beyond the owner of the assets (i.e. the trustee) to the beneficiaries, then the transparency regime is necessarily limited.

With regards to the implementation of the EU Fifth Anti-Money Laundering Directive (5MLD), the effect of including all "express trusts" in registration requirements will be much greater in Scotland than in other UK jurisdictions. In Scotland, trusts are "express" in the sense that they are created by deed. This includes, for example, conveyancing missive trusts, trusts used in purchase and sale asset deals, indemnities for fund and other asset managers, joint deposit clauses, and assets held by unincorporated associations. Many, but not all, of these examples are bare trusts. We understand that a number of these examples would achieve the same legal result in England by way of an implied rather than express trust. This demonstrates the discrepancies which may arise if a wide view of "express trusts" is taken and the likely disproportionate effects for some Scottish trusts. Including bare trusts, pilot trusts, life policy trusts and trusts holding only houses or investment bonds will cause a significant amount of work for settlors, trustees and advisers. This may discourage individuals from setting up such trusts which may be to their serious financial disadvantage. A general exclusion from registration requirements for bare trusts would go a long way towards reducing the practical problems which may be faced.

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

We note that a variety of rules have been introduced to tackle the issues surrounding off-shore trusts and in most situations, there are no longer benefits to holding assets in an off-shore trust, certainly for those who remain fully connected to the UK. Assets can no longer be sheltered from inheritance tax or in the case of land and buildings, from capital gains tax. It appears that the vast majority of such trusts are now being used for genuine estate planning.

We question whether the UK should have an interest in information and taxation off-shore trusts for off-shore beneficiaries. Currently the UK has an interest in this where the settlor is UK resident. Difficulties arise in situations where trustees are subject to requirements of UK law without being aware of such requirements. It is not clear how compliance with the law can be achieved in such circumstances.

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.

We refer to our answer to question 3. We note that circumstances in which it is advantageous to use a non-resident trust over a UK resident trust will now be very limited and, anecdotally, such vehicles are used for genuine purposes such as to use a trust to hold assets for family members who already live out-with the UK; or who may do so in future. This is particularly the case where trust assets may accumulate in jurisdictions with lower tax rates than the UK

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.

It is wholly inappropriate for avoidance and evasion to be considered as analogous matters. We do not condone behaviour by our members who engage in or advise on conduct that could constitute evasion or inappropriate avoidance. The boundary between avoidance, and acceptable and encouraged tax planning is necessarily fluid.

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.

The IHT rules on trusts are difficult for trustees, advisers and HMRC and would merit simplification. It is common for assessments by HMRC to be issued some 12 months after IHT100 forms are submitted.

We note the comparison made at page 14 of the consultation document in relation to holding assets outright until death. We consider this to be a false comparison as the assets in trust are not part of the deceased's estate. Such assets will be subject to taxation within the trust.

The value of the nil rate band is not in keeping with its historical value as a result of inflation.

We suggest that this presents an opportunity for simplification in relation to the successive seven year charges.

With regards to will trusts, we note that these will have been subject to a 40% IHT charge on the death of the settlor unless there is an unused nil rate band. It is inconsistent for qualifying interest in possession trusts to be treated differently on death from those established during lifetime.

A suggestion may be for the link to the settlor's nil rate band (and the settlor's IHT position generally) to be removed. Trusts subject to the relevant property regime could pay IHT at a flat rate every 10 years on the value of the trust assets over the nil rate band. Capital distributions within the 10 year period could be taxed at the same rate but reduced to take account of the number of years (rather than quarters) since the last 10-year charge. Even if change did not go this far, we suggest that it should be a priority to simplify the regime for relevant property trusts, where the costs of compliance can often exceed the tax payable.

We consider it is beneficial to retain immediate post-death interest (IPDI) trusts as these are commonly used for children in order to utilise the residence nil rate band; and are particularly valuable to families with children from more than one relationship, where provision is made for a surviving partner but with the certainty that assets will ultimately pass to the descendants of the deceased.

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.

With regards to private residence relief from capital gains tax, the notion of this is to give exemption to those who live in the property. The relief can be claimed only on one property in which an individual is residing. We consider that it is important that there is transparency as to who is residing there in order to assess the tax liability, rather than who is the owner. Given the basis for the relief, we consider that it is important that this relief remains available.

In relation to Trust Management Expenses, the practice varies considerably and could be simplified. We recognise that the greater the expenses, the lesser the income going elsewhere. We consider that there is no difference in economic terms between trusts and individuals in this regard as individuals will have less money as a result of expenses incurred in the same way as trustees. Trusts may also be compared to companies whereby dividends are only paid after the deduction of company expenses.

Where trustees are making a return of income, an alternative system would be to permit a deduction of a fixed percentage of the gross income (say 10%) and pay tax only on the net figure. Such a system could also apply to CGT.

Turning to income and capital receipts, we note that it can be difficult to determine whether receipts are income or capital. We consider that this is an issue arising from trust law rather than tax law. Modern trust deeds generally give trustees discretion to decide on the position.

Finally, in relation to trusts and transactions that are declared void, we consider that this is also a trust law issue where the legal overlay does not match with the tax liability. If a transaction is declared void, then it should be treated as void. HMRC already have the opportunity to make representations in such cases.

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

We note that trusts are often an important tool for people with disabilities and can be a mechanism for overcoming disadvantages resulting from disabilities. As such, the wider issues around taxation of trusts should be considered in the context of the role trusts play for many vulnerable individuals. Trusts for vulnerable beneficiaries could be a “measure relating to the exercise of legal capacity” in terms of Article 3 of the UN Convention on the Rights of Persons with Disabilities (CRPD). Often they are created only because of the disabilities giving rise to the relevant vulnerability. Otherwise, the principal beneficiary may have received the funds in question and would not need the structure of a trust to administer them. It is important to note that, in order to comply with the provisions of the CRPD which require a disabled person to be treated “on an equal basis with others”, the vulnerable beneficiary must not be subject to unfavourable treatment in comparison with non-disabled persons holding and administering relevant funds themselves – for example, there must be no unfavourable taxation treatment, no ‘penalty’ in the form of additional administration costs and no disadvantage in relation to privacy. Any disadvantages placed upon the vulnerable beneficiary by reason of disability could warrant a complaint to the UN Committee on the Rights of Persons with Disabilities under the First Protocol to CRPD.

We consider that there requires to be a root and branch review of vulnerable beneficiary trusts. The law in this area has developed in a piecemeal fashion and varies considerably across the taxes. As a result, it is common for there to be confusion as to the regimes for IHT, income tax and capital gains tax. In particular, the overlap and inconsistencies between vulnerable beneficiary trusts for income tax and capital gains tax and disabled trusts for inheritance tax require to be addressed.

There would be merit in a clear distinction being drawn between 18 to 25 and bereaved minors trusts, and between ‘vulnerable beneficiary’ trusts more generally. The former will be ‘vulnerable’ for a limited time only whereas the latter may be likely to remain ‘vulnerable’ for a longer period. In particular, ‘vulnerable’ requires to be clearly defined, and the interaction with guardianship and arrangements for means testing clarified.

If there is a desire to support vulnerable beneficiaries (as distinct from children), one option would be to take the approach that all income received by ‘vulnerable beneficiary’ trusts should be tax free until it is paid out to the vulnerable beneficiary. At such time, the income would be taxed at that beneficiary's personal tax rate. This would require to be carefully defined in order to avoid abuse, for example, by being restricted to trusts where only the vulnerable beneficiary could receive any income.

In respect of trusts for children (regardless of whether or not they are the children of the settlor), these could be excluded from having to pay IHT as long as the trust provides for the capital to be distributed at or before age 25.

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.

With regards to settlor interest trusts, we suggest a return to the system where the income is returned, the tax on it is paid by the settlor only and the trustees do not require to get involved. The current administrative burden on trustees can be demanding. We note that this should apply to true settlor interest trusts only and not, for example, to trusts for minor children.

In the context of executries, and perhaps trusts more widely, we consider that there would be merit in the extension of the current concession relating to interest in executries where there is no need to report the interest and pay tax if the tax payable is less than £100. At a 20% tax rate, this equates to £500 of interest. At present, as soon as an estate or trust receives a dividend, perhaps even of only £1, the concession is lost, and the dividend and all the interest requires to be returned and tax paid. We suggest that there would be merit in both executries and trusts having a meaningful allowance (perhaps £1,000 a year for each type of income) below which executors and trustees would not have to make a return. If the interest and/or dividends were above that allowance, the value up to the allowance could be tax free. Such allowances would require to be split if a settlor has set up more than one trust and would co-ordinate with the beneficiaries' corresponding allowances so that their allowances were not increased because some of their income accrued via a trust. This would allow for dividends to be passed directly to beneficiaries and to be treated as the income of the beneficiaries.

We also suggest that it should be possible for trustees and beneficiaries jointly to elect that the trust income payable to the beneficiary should be returned and the tax paid by that beneficiary rather than by the trustees. At present, this possibility arises only where the trust income is "mandated" to the beneficiary. It is unclear what this really means. It perhaps refers to a situation which now rarely applies where trustees hold shares directly and lodge a dividend mandate with the registrars in favour of the beneficiary. With increased use of nominee accounts, such circumstances likely now apply mainly to private company shares. For the sake of simplicity, where there is more than one income beneficiary, the "mandated" treatment would have to apply to all or none. This would facilitate dividends being passed directly to the income beneficiary in an interest in possession trust. We suggest that this be balanced by an exclusion from claiming Trust Management Expenses for such trusts.

In addition, we note that it is not clear why there is no income tax allowance for trusts or why the capital gains tax allowance is only half of that of an individual's allowance (split between all trusts established by the same settlor, a rule which can readily lead to inadvertent errors in the amount of allowance available).



For further information, please contact:

Alison McNab

Policy Team

Law Society of Scotland

DD: 0131 476 8109

AlisonMcNab@lawscot.org.uk