HM Revenue & Customs

The Taxation of Trusts: A Review

Consultation document
Publication date: 7 November 2018
Closing date for comments: 30 January 2019

Subject of this consultation:	The principles underpinning the taxation of trusts and the extent to which the status quo aligns with them.
Scope of this consultation:	This consultation sets out the principles that government believes should underpin the taxation of trusts – transparency, fairness 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.
Who should read this:	This consultation will be of interest to: members of the public; those that set up, administer or benefit from trusts; law firms and representative bodies; and tax professional and representative bodies.
Duration:	7 November 2018 to 30 January 2019 (12 week consultation exercise).
Lead officials:	Alan McGuinness, HMRC
How to respond or enquire about this consultation:	Trusts Tax Reforms Consultation Assets and Residence Team Business, Assets and International Directorate HM Revenue and Customs 100 Parliament Street London SW1A 2BQ or by email to: asres.consult@hmrc.gsi.gov.uk
Additional ways to be involved:	Please contact the lead officials if you are interested in meeting to discuss this paper.
After the consultation:	Following the consultation period the response document will indicate whether the government is minded to propose any specific changes based on the suggestions received. If so, there will be further consultations on detailed proposals at that point.
Getting to this stage:	This consultation sets out the government's thinking so far on making trust taxation fairer, simpler and more transparent.
Previous engagement:	This is the first consultation to examine trust taxation overall.

Contents

On request this document can be produced in Welsh and alternate formats including large print, audio and Braille formats

1. Executive Summary

1.1 This consultation is being published in line with the government's commitment at Autumn Budget 2017 to consult on how to make the taxation of trusts simpler, fairer and more transparent.

1.2 Chapter 2 provides an introduction to the process the government has undertaken in assessing trust taxation, and describes our intentions going forward.

1.3 Chapter 3 looks at existing trust usage within the UK, and our proposed policy principles underpinning trust taxation: transparency, fairness and simplicity.

1.4 Chapter 4 looks at the principle of transparency, in particular in relation to non-resident trusts. It describes ongoing initiatives that enhance trust transparency – the Common Reporting Standard and the Trusts Registration Service – and requests views on whether further measures are required. It also touches on concerns regarding the potential for avoidance and evasion in respect of non-resident trusts in particular; and seeks views on the extent of that avoidance and evasion and how it can be tackled.

1.5 Chapter 5 looks at the principle of fairness and describes the government's approach to ensuring that trusts do not offer either a tax advantage or disadvantage. It describes aspects of the interaction between Inheritance Tax and trusts, touches on some other aspects of trust taxation and seeks views on the case for reform.

1.6 Chapter 6 looks at the principle of simplicity. It describes the government's interest in simplifying the approach to taxation for Vulnerable Beneficiary Trusts and seeks views on the options, as well as touching on other aspects of trust taxation that might warrant simplification.

1.7 Chapter 7 summarises the consultation questions and Chapter 8 sets out the process for response.

1.8 A high level outline of the existing trust taxation system is provided at the Annex.

2. Introduction

2.1 At Autumn Budget 2017, the government announced its intention to publish a consultation in 2018 on how to make the taxation of trusts simpler, fairer, and more transparent[1].

2.2 This consultation is intended to:

2.2.1 set out the government's principles for taxing trusts, and seek views on those principles;

2.2.2 assess the extent to which the current trust taxation system aligns successfully with those principles; and,

2.2.3 seek views and evidence on the case for and against reforms to address any areas of trust taxation which do not currently align with those principles.

2.3 At this stage, the government is not making specific proposals for reform. The government will consider the views and evidence presented in response to this consultation, and weigh up the options for targeted reforms accordingly.

2.4 Trusts are an intrinsic part of the UK's legal system, and have been in use for centuries. The government wishes to ensure that the many UK individuals and companies using trusts legitimately benefit from a clear and transparent regime that is easy to understand, while also taking steps to ensure that trust taxation does not produce unfair outcomes and that trust structures do not facilitate tax avoidance or evasion.

2.5 For simplicity, the terminology in this document uses terms appropriate to trusts constituted under the law of England and Wales. This does not restrict this consultation solely to such trusts, and does include trusts constituted under Scots Law for instance (so references to settlor (England and Wales) should be read to include references to truster (Scots Law) for example).

2.6 This consultation is being published alongside research carried out in September-December 2016 by Ipsos MORI on why people use trusts.

2.7 The Annex summarises the main tax rules for trusts.

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[1] Autumn Budget 2017: paragraph 3.9
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661480/autumn_budget_2017_web.pdf

3. Trust Usage and Policy Principles

3.1 A person, whether an individual or a company, can place most types of assets into a trust. They would then be known as the settlor of that trust. A trust is the legal obligation that results when a settlor appoints themselves and/or another person/s (the trustee/s) to hold and manage assets (the trust property) for the benefit of a person or persons (the beneficiaries).

3.2 There are a wide variety of types of interest under a trust. For example, a beneficiary may have an entitlement to all the income, or use of assets, of the trust; or there may be a list of potential beneficiaries who may benefit from the trust income or assets at the discretion of the trustees.

3.3 The effect of creating a trust is thus to separate the legal ownership of assets from the benefits arising from those assets – although the same person may be a settlor, trustee, and/or a beneficiary of a trust.

3.4 There is nothing wrong with this in principle – indeed, there are many circumstances throughout UK society in which trusts play a valuable role. For example:

3.4.1 Many charities are set up in the form of a trust, ensuring that funds and property can be protected and utilised for the benefit of a good cause.

3.4.2 Some people are unable to manage their own affairs. Assets can be placed in trust for their benefit, allowing others to support them by helping to manage their finances.

3.4.3 A minor child is not able to own property in their own right. But property can be placed in trust for them during their minority, for example where the child's parents have died.

3.4.4 A trust may be used to ring-fence funds to ensure consumer protection (such as landlords holding tenants' deposits or travel companies holding funds provided for holidays), for other commercial purposes (such as providing security for contracts) or to fulfil an obligation (such as in relation to the future decommissioning of oil fields).

3.4.5 A trust may be used to hold a business or other valuable assets for the benefit of family members, rather than fragmenting ownership.

3.5 It is important that this separation between the ownership of assets and the benefits arising from them should not prevent HMRC from being able to assess the overall tax liabilities for all parties, nor affect other Government bodies' abilities to ensure that other legal requirements are complied with. Increased transparency of trusts – in the sense of ensuring that Government bodies have information on all parties to any given trust, and also (where appropriate) in the sense of full transparency for the wider public – is discussed in detail in Chapter 4.

3.6 In the past, this separation did allow those intent on paying less than their fair share of tax to design and use trust structures as a means to avoid or evade tax. For instance, by moving assets or funds out of their own legal ownership, they could reduce their overall tax liabilities, while continuing to benefit from the use of the assets or funds they transferred.

3.7 In many cases, successive reforms now prevent this sort of avoidance. For example:

3.7.1 The income of a settlor-interested trust (one where the settlor retains some ability to benefit) is generally attributed to the settlor in the same amount as would have been the case if the settlor owned the property outright.[2]

3.7.2 Payments from a trust to a settlor's dependent minor children are taxed as the settlor's income in the same amount as would have been the case if the settlor owned the property outright.[3]

3.7.3 If an individual sets up multiple 'pilot trusts'[4], they do not thereby receive multiple Inheritance Tax nil-rate bands when property is then settled to those trusts on a later day.[5]

3.8 However, the government continues to have some concerns around the ways in which non-resident trusts are used, which are discussed further at paragraphs 4.13 to 4.15.

3.9 The government now wishes to:

3.9.1 address any remaining opportunities to use trusts, in particular non-resident trusts, for tax avoidance or evasion;

3.9.2 ensure that our approach to trust taxation does not result in unfair outcomes or other unintended consequences; and

3.9.3 facilitate the straightforward usage of trusts where they are the appropriate legal mechanism.

3.10 The policy principles which the government has used to test the efficacy of the trust taxation system are therefore:

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[2] Section 624 of the Income Tax (Trading and Other Income) Act 2005

[3] Section 629 of the Income Tax (Trading and Other Income) Act 2005

[4] A 'pilot trust' is a trust set up with a nominal amount of property

[5] Section 11 of, and Schedule 1 to, the Finance (No 2) Act 2015

3.10.1 **Transparency**: Trusts should be sufficiently transparent so that they cannot be used to hide the beneficial ownership of funds or assets; and non-resident trusts should be sufficiently transparent for government to ensure that such trusts do not offer the opportunity to avoid or evade UK tax liabilities.

3.10.2 **Fairness and Neutrality**: Trust taxation should be fiscally neutral: their tax treatment should neither encourage nor discourage the use of trusts. In particular, trusts should not offer tax avoidance opportunities.

3.10.3 **Simplicity**: Trust taxation, and the accompanying administrative processes, should be sufficiently straightforward that the tax system does not disincentivise the use of trusts when it is appropriate for them to be used; and minimises the likelihood of error.

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

3.11 The following chapters set out the government's detailed thinking on these principles, and make an initial assessment of the extent to which the current trust taxation system complies with them.

4. Transparency

A. Policy Principle

4.1 Offshore tax avoidance and evasion pose international challenges, as well as domestic ones. The UK has long been leading the way in tackling these issues in collaboration with other jurisdictions, and published a strategy to tackle offshore tax evasion in 2013 (‘*No Safe Havens*’, updated in 2014).

4.2 Transparency is a key concern for revenue authorities and others. While trusts can offer privacy in managing a person’s affairs, there is a clear distinction between that privacy and keeping such arrangements deliberately concealed from a public authority such as HMRC for the purposes of tax avoidance or evasion.

4.3 The government considers that trusts, whether UK resident or non-resident, should be sufficiently transparent that the separation of the ownership of assets and the benefits arising and those who benefit from them is not hidden. In particular the separation should be transparent to those responsible for administering the tax system or investigating criminal activity such as money-laundering or terrorist financing.

B. Action underway

4.4 The government is currently taking forward two major initiatives that will have a significant impact on transparency for trusts: the Common Reporting Standard and implementation of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the MLRs).

4.5 The OECD Common Reporting Standard (CRS) is the global standard for the automatic exchange of financial account information between tax authorities, to help tackle tax avoidance and evasion. Around 100 jurisdictions are committed to exchange information in 2018. Broadly speaking, Financial Institutions have reporting obligations in relation to financial accounts they hold for non-resident persons. Under CRS rules, trusts can be defined as a reporting financial institution, meaning UK tax residents who are settlors, beneficiaries, trustees or otherwise exercise control over non-resident trusts are reported to HMRC by other countries. Similarly, the UK collects and reports information to other countries on UK resident trusts with non-UK resident controlling persons.

4.6 The MLRs established the Trusts Registration Service (TRS), an online register of the beneficial ownership of all tax-paying trusts, which went live in July 2017 in compliance with the EU Fourth Anti-Money Laundering Directive (4MLD). The MLRs also impose a legislative obligation on trustees of UK-resident express trusts and non-UK express trusts that generate a UK tax consequence to hold written, accurate and up-to-date records of their beneficial owners and to make these available to UK law enforcement authorities on request.

4.7 The UK is now preparing to expand the TRS in line with the requirements of the EU Fifth Anti-Money Laundering Directive (5MLD), which entered into force at EU level on 10 July 2018, with transposition and implementation deadlines of 10 January 2020 and 10 March 2020 respectively. This is expected to be during the Implementation Period following the UK ceasing to be a Member State of the European Union. 5MLD will require registration of all UK express trusts – not just those liable for UK tax, as at present – and non-EU trusts that acquire UK real estate. Further discussion of these issues will be within a separate 5MLD consultation to be published in Winter 2018/19, therefore they are not covered in detail here.

4.8 While the above processes are expected to be a major step towards ensuring the genuine transparency of trusts, the government is interested in exploring whether there are any other steps it could take in this area.

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.

C. Trust tax residence

4.9 Alongside the actions above to enhance trust transparency, the government considers that further consideration is required in particular in relation to the use of trusts that are not UK resident for tax purposes.

4.10 A trust is UK resident for Income Tax and Capital Gains Tax purposes if all the trustees are UK resident; or, if there are both resident and non-resident trustees, the settlor was resident or domiciled in the UK when they made or added property to the trust (or, where the trust arises following the settlor's death, was so resident or domiciled immediately prior to death).[6]

4.11 The above definition has the following implications:

4.11.1 It is relatively straightforward for UK resident individuals to set up non-resident trusts for Income Tax and Capital Gains Tax purposes. Although such trusts will in general still be liable for UK tax on UK source income and gains on certain UK land[7]; and, as explained at

[6] Section 475 of the Income Tax 2007 and section 69 of the Taxation of Chargeable Gains Act 1992. For Inheritance Tax (IHT) purposes, the residence of trustees does not affect the charges to IHT (although it may impact the persons liable to pay the tax).
[7] At the time of writing, non-resident trusts are liable to CGT when disposing of residential UK property. There are proposals to extend the scope of CGT from April 2019 for non-resident trusts (and other non-

paragraph 3.7, anti-avoidance provisions tax UK resident and domiciled settlors on the worldwide trust income and gains.

4.11.2 Trusts set up using UK resident trustees will be UK resident trusts even when the settlor is resident and domiciled overseas or when there are no UK beneficiaries. Such trusts would be charged to tax on their worldwide income and gains, which can potentially discourage overseas settlors from using UK trusts.

4.12 Notwithstanding these implications, the government recognises that any attempt to take a different approach to this definition would constitute a fundamental change to trust taxation policy, and would only be warranted if it constituted a significant improvement in comparison to the current method.

Question 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 on any other potential options.

4.13 The UK's National Risk Assessment of Money Laundering and Terrorist Financing gives the view that, "*The risk of criminals exploiting UK trusts to launder money is therefore assessed to be low. The precise extent of abuse of UK trusts remains an intelligence gap. However, there are significantly higher risks associated with overseas trusts.*"

4.14 The government's anti-avoidance legislation is generally intended to ensure that a person using a non-resident trust rather than a UK resident trust does not gain a tax advantage from so doing[8]. However, the government is concerned that it can nevertheless be difficult to establish the facts in order to determine whether the relevant rules have been complied with.

4.15 Bearing the concerns detailed above in mind, and recognising that, as set out in paragraph 3.7, reforms have addressed historical uses of trusts for avoidance, the government wishes to understand in greater detail the reasons a present-day UK settlor might have for choosing to settle assets into a non-resident trust rather than a UK resident trust. The government is concerned that non-resident trusts may continue to be used for tax avoidance or evasion under some circumstances. This includes exploiting remaining loopholes within tax avoidance schemes.

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residents) to include gains on disposals of non-residential UK property and interests in UK property rich entities.

[8] An exception is the arrangements for trusts relating to non-domiciled individuals that came into force in 2017: See Schedule 8 of Finance (No.2) Act 2017 and *Reforms to the taxation of non-domiciles: response to further consultation* https://www.gov.uk/government/consultations/reforms-to-the-taxation-of-non-domiciles-further-consultation

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.

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.

5. Fairness and Neutrality

A. Policy Principle

5.1 As set out in Chapter 2, trusts are a longstanding part of UK law, fulfilling a range of functions in society. The government wishes to take a fair approach to trust taxation in this context, ensuring that tax considerations neither incentivise nor disincentivise the use of trusts.

5.2 The policy principle underlying the taxation of trusts is therefore neutrality: the starting principle is that tax should neither encourage nor discourage their use and only deviate from this principle where there are clear policy reasons to do so.

5.3 However, the complicating factor when assessing neutrality is determining which comparator to use. It is possible to approach trust taxation as though the property and/or income of the trust still belongs to the settlor – because the property has not been given outright to the beneficiaries. Alternatively, the property and/or income could be considered to be given free and clear to the beneficiaries without the use of a trust. These different comparative scenarios can give very different results, as can a third option of taxing the property or income as belonging to, and only to, the trustees themselves.

Which of these possible approaches is genuinely 'neutral' depends on the specific terms of the trust and the circumstances of the persons in question.

5.4 At present, the main taxes that apply in relation to trusts (Income Tax, Capital Gains Tax and Inheritance Tax) contain rules based on the outcomes of different comparators depending on the type of trust, the person(s) benefitting and the tax involved. This variation is in recognition of the different nature of those taxes, and of the types of trust involved.

B. Potential Issues

5.5 In most cases, the government believes the resultant tax regimes, though necessarily complex, produce a broadly neutral result as they take into account the nature of the trust and who is benefitting from it. However, there are some possible exceptions in relation to Inheritance Tax (IHT), as follows, on which we would welcome views.

5.5.1 **The IHT nil rate band[9]:** An immediate charge to IHT arises on chargeable lifetime transfers that exceed, when aggregated with other chargeable transfers in the preceding seven years, the transferor's available IHT nil rate band (currently £325,000). Chargeable transfers

[9] Section 7 of, and Schedule 1 to, the Inheritance Tax Act 1984

include transfers by settlors to set up 'relevant property' trusts – a common form of trust.

Ipsos MORI research published alongside this consultation found that settlors choose to place their wealth into such trusts up to this amount every seven years in order to take advantage of this rule.

Such arrangements can be beneficial in comparison with holding those assets outright until death (since the assets would normally no longer form or be treated as part of the settlor's estate); and so can be seen as a means of obtaining additional nil rate bands.

Alternatively, the arrangements can be seen as neutral in comparison with making potentially exempt transfers (PETs) up to the same value over the same period (albeit that the use of a trust may mean individual beneficiaries may not receive benefit for some time). However, compared with making PETs to individuals, where an unlimited amount can be transferred without a charge to IHT provided that the transfer does not become a 'failed PET' on the transferor's death, the seven year rule restricts how much can be placed in trust without an immediate charge arising.

5.5.2 **Trust IHT charges**[10]**:** For relevant property trusts that exceed the available nil rate band, an immediate charge (often called an 'entry charge') of up to 20% is paid by the settlor when the trust is set up. Each ten years thereafter a further 'periodic' charge of up to 6% is payable by the trustees. The government has received representations stating that the upfront 20% entry charge constitutes an unfair charge on the use of trusts.

In comparison with the settlor holding the assets until death and their estate being charged to IHT at that time, the combination of charges described above, along with any lost returns from paying those charges, may or may not be beneficial overall depending on the lifespan of the trust in comparison with the date of the settlor's death.

When considered from the perspective of taxing the property as currently belonging to, and only to, the trustees themselves, total IHT charges of up to broadly 38% will be paid during the first 30 years (a period equivalent to a generation) on amounts above the nil rate band. This is made up of the 20% entry charge and three 10-year periodic charges of 6%. This can be seen as generating a near-neutral outcome over this period when compared to an individual passing the same assets (and only those assets) directly from one generation to the next; although we recognise that in practice factors such as the timing of

[10] Sections 64 to 69 of the Inheritance Tax Act 1984

these charges make a direct mathematical comparison over-simplistic. That said, when considering the tax paid during the second and subsequent 30-year 'generations', as no further 20% entry charge is due, broadly 18% IHT will be paid every 30 years (three 6% 10-year periodic charges paid by the trustees), which is significantly lower than the 40% paid by estates at death.

5.5.3 **Will trusts:** These are trusts that are set up using some or all of the assets in an estate following a death. Those assets may have been subject to a 40% IHT charge on the death of the settlor.

As opposed to trusts set up in a settlor's lifetime, the transfer from the deceased's estate is not subject to a 20% entry charge; but when the trust is a relevant property trust, the 6% 10-year periodic charges are payable in the same way as for relevant property trusts set up in a person's lifetime.

Other forms of trust ('qualifying interest in possession trusts') are taxed on the beneficiary's death as if the assets are part of the beneficiary's estate. The range of such trusts that can be created by will is wider than those created in a person's lifetime.

We wish to consider whether the above is the right framework to tax settlors, trustees and beneficiaries to IHT in the future.

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.

5.6 There are also some more detailed points that may constitute exceptions to the principle of fairness and neutrality, on which the government would welcome views:

5.6.1 **Capital Gains Tax (CGT) – Private Residence Relief[11]:** Information on Private Residence Relief can be found in HMRC's Helpsheet 283[12]. Broadly, gains on the disposal of a dwelling by an individual are relieved from CGT to the extent that the person making the disposal has occupied the property as their only or main residence during their ownership of it. But gains on rental properties and second homes would normally be chargeable to CGT.

Private residence relief may also apply to gains on the disposal of a dwelling by trustees to the extent that it has been occupied as the only

[11] Section 225 of the Taxation of Chargeable Gains Act 1992
[12] https://www.gov.uk/government/publications/private-residence-relief-hs283-self-assessment-helpsheet

or main residence of a person entitled to occupy it under the terms of the trust. To the extent that that person also then benefits from the proceeds from the dwelling's disposal, this produces a neutral outcome in comparison to an individual selling their own home. However, under the terms of a trust, the proceeds from a dwelling's disposal might be applied for the benefit of a different beneficiary, or indeed the settlor. This can result in an outcome that is not neutral.

5.6.2 **Trust Management Expenses**[13]**:** Information on Trust Management Expenses can be found in HMRC's Helpsheet 392[14]. Broadly, in managing a trust, the trustees may incur expenses in the course of exercising their duties and powers. Expenses incurred exclusively in relation to trust income, such as in relation to the making of Income Tax returns, can reduce Income Tax liabilities either for the trustees or the beneficiaries depending on the type of trust in question. This treatment of expenses is more generous than that for individuals who incur costs in managing their affairs, and therefore does not produce a neutral outcome.

5.6.3 **Income and capital receipts in trust law**[15]**:** If trustees' receipts are capital in trust law then in most cases they are not taxable at the special trust rates, nor are they taxable at the marginal rates of an income beneficiary. Instead, they are taxable at the basic rate of Income Tax, or at Capital Gains Tax rates, both significantly lower than the special trust rates and the higher rates for individuals. This difference in rates of taxation can lead to disputes as to whether a receipt is income or capital in trust law. This can result in an outcome that is not neutral in comparison to other taxpayers who would not have the same considerations when classifying income and capital.

5.6.4 **Trusts and transactions declared void by the courts:** Sometimes individuals, settlors, trustees or other persons incur tax consequences they did not anticipate. This might be because they made a mistake about the legal effect of a transaction or deed, or received inadequate or incorrect tax advice, or their attempt at tax avoidance failed. A person in this position may apply to a court to try to have the relevant transaction or trust declared void. Where successful, the steps that have taken place are set aside. This may affect the tax outcome. In some circumstances this may be appropriate – for example, to deal with a mistake about the legal effect of the deed or transaction. However, in other situations, it produces an unfair tax outcome.

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[13] Sections 484 to 487 and 499 to 503 of the Income Tax Act 2007
[14] https://www.gov.uk/government/publications/trust-management-expenses-tmes-hs392-self-assessment-helpsheet
[15] Sections 479 and 480 of the Income Tax Act 2007

Question 7: The government seeks views and evidence on:

a) **the case for and against targeted reform in relation to any of the possible exceptions to the principle of fairness and neutrality detailed at paragraph 5.6;**
b) **any other areas of trust taxation not mentioned there that would benefit from reform in line with the fairness and neutrality principle.**

6. Simplicity

A. Policy Principle

6.1 The government is committed to increasing the simplicity of the UK tax system and making the tax system more responsive to users' needs.

6.2 In the case of trusts, the tax system is in many cases necessarily complex, due to:

6.2.1 the wide-ranging effects that setting up and running a trust can have;

6.2.2 the variety of different types of trust that exist and which must be accommodated by the tax system;

6.2.3 the range of taxes involved; and

6.2.4 the need to ensure fairness of tax treatment between trust users and those that decide to manage their wealth and assets outside of a trust.

6.3 Nonetheless, the government's intention is that trust taxation should not be so complex that it discourages the use of a trust where it would be the most suitable legal arrangement to achieve a settlor's legitimate goals. Moreover, we recognise that administrative processes and forms may also benefit from simplification, as well as or instead of any simplification of the tax treatment to which those processes and forms relate.

B. Possible Issues

6.4 In the case of trusts known collectively as 'Vulnerable Beneficiary Trusts' (trusts for beneficiaries with a disability or for bereaved minors), the government is aware that stakeholders have previously expressed concerns that the complexity of Income Tax and Capital Gains Tax rules limits the use of the available tax reliefs by those who should benefit. There are also concerns about the effectiveness of the Income Tax relief, given that the tax pool mechanism can lead to a secondary charge.

6.5 The government is committed to taking action to simplify the treatment of these trusts and to ensure the effectiveness of reliefs. At this stage, the government would welcome views on the tax treatments that these trusts receive, alongside their interaction with 'age 18 to 25' trusts (a continuation of bereaved minor trusts used in some circumstances).

6.6 In parallel, the government is interested in views and evidence on other drivers of excessive complexity in the trust taxation system. For example, we recognise that one key determinant of the complexity of the present trust taxation system is the need for trustees to liaise with the settlor or beneficiaries (as the case may be) to ensure that all parties pay the correct amount of tax, rather than there being a standalone or simplified regime either for all trusts, or for those trusts whose settlors or trustees would welcome a reduction in administrative burdens. That said, the government recognises that taking a different approach would constitute a fundamental change to trust taxation policy, and would only be warranted if it constituted a significant improvement in comparison to the current rules.

6.7 Finally, the Government is interested in views and evidence on all other complex administrative aspects of the trust taxation system. For example:

6.7.1 The government is aware that for many small trusts, Income Tax administrative requirements can seem unduly onerous, especially where the tax due is low.

6.7.2 The Ipsos MORI research demonstrates that the cost of employing an agent to calculate the IHT periodic charges for a trust can outweigh the cost of the tax itself.

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

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.

7. Summary of 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.**

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.**

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.**

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.**

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.**

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.**

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.**

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

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.**

8. The Consultation Process

This consultation is being conducted in line with the Tax Consultation Framework.

There are 5 stages to tax policy development:

Stage 1 Setting out objectives and identifying options.

Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.

Stage 3 Drafting legislation to effect the proposed change.

Stage 4 Implementing and monitoring the change.

Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stage 1 of the process. The purpose of the consultation is to seek views on the policy design and any suitable possible alternatives, before consulting later on a specific proposal for reform.

How to respond

A summary of the questions in this consultation is included at Chapter 7.

Responses should be sent by 30 January 2019, by e-mail to asres.consult@hmrc.gsi.gov.uk

or by post to:

Trusts Tax Reform Consultation, Assets and Residence Team, Business, Assets and International Directorate, HM Revenue and Customs, 100 Parliament Street, London, SW1A 2BQ

Please do not send consultation responses to the Consultation Coordinator.

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from HMRC's GOV.UK pages. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection

Act 2018, General Data Protection Regulation (GDPR) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue & Customs.

Consultation Privacy Notice

This notice sets out how we will use your personal data, and your rights. It is made under Articles 13 and/or 14 of the General Data Protection Regulation (GDPR).

Your Data

The data

We will process the following personal data: Name

Purpose

The purpose(s) for which we are processing your personal data is to record responses to a public consultation: *Taxation of Trusts: A review*

Legal basis of processing

The legal basis for processing your personal data is that the process is necessary for the exercise of a function of a government department.

Recipients

Your personal data will be shared by us with HM Treasury.

Retention

Your personal data will be kept by us for six years and will then be deleted.

Your Rights

- You have the right to request information about how your personal data are processed, and to request a copy of that personal data.
- You have the right to request that any inaccuracies in your personal data are rectified without delay.
- You have the right to request that any incomplete personal data are completed, including by means of a supplementary statement.
- You have the right to request that your personal data are erased if there is no longer a justification for them to be processed.

- You have the right in certain circumstances (for example, where accuracy is contested) to request that the processing of your personal data is restricted.

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If you consider that your personal data has been misused or mishandled, you may make a complaint to the Information Commissioner, who is an independent regulator. The Information Commissioner can be contacted at:

Information Commissioner's Office
Wycliffe House
Water Lane
Wilmslow
Cheshire
SK9 5AF
0303 123 1113
casework@ico.org.uk

Any complaint to the Information Commissioner is without prejudice to your right to seek redress through the courts.

Contact Details

The data controller for your personal data is HM Revenue & Customs. The contact details for the data controller are:

HMRC
100 Parliament Street
Westminster
London
SW1A 2BQ

The contact details for HMRC's Data Protection Officer are:

The Data Protection Officer
HM Revenue & Customs
7th Floor, 10 South Colonnade
Canary Wharf
London E14 4PU
advice.dpa@hmrc.gsi.gov.uk

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

If you have any comments or complaints about the consultation process please contact:

John Pay, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex: Current Trust Tax Framework

A. Inheritance Tax (IHT)

IHT is a tax on transfers of value, such as when a gift is made or assets are passed to another person when someone dies.

When a person dies, they are treated as if they had made a chargeable transfer immediately before their death equal to the value of their estate. IHT is charged on the value of the deceased's estate and any transfers of value made in the preceding seven years that are not exempt. IHT is charged at 40% of the total value that exceeds the IHT nil rate band. The available nil rate band may be enhanced by making use of the amount of unused nil rate band of a pre-deceased spouse or civil partner and a residence nil rate band.

The IHT treatment of trust assets differs depending on whether the trust is within one of two broad categories of trust:

- *Qualifying interest in possession (QIIP) trusts* – These are certain trusts where a beneficiary has (or is deemed to have) the right to receive the income from the trust or to use assets comprised in it. Where a QIIP exists, the beneficiary with the interest is treated as beneficially entitled to the trust assets. This means that the assets are treated as part of their estate and so are subject to IHT on their death. New QIIP trusts that can be created are limited to 'immediate post death interest' trusts and qualifying 'disabled person' trusts.

- *Relevant property trusts* – Most trusts that are not QIIP trusts come within this category. Subject to exemptions and reliefs, a transfer into this type of trust is immediately chargeable to IHT when the trust is established, or added to, during the settlor's lifetime. The tax is paid by the settlor at 20% of the reduction in the settlor's estate because of assets added to the trust, less the settlor's available nil rate band. Additionally, the trustees are subject to 'relevant property' IHT charges consisting of:

    - charges at up to 6% of the value of the trust assets every ten years (the '10-year periodic charge'); and

    - 'exit charges' based on a time apportionment of the 6% 10-year periodic charge when assets cease to be relevant property, for example when transferred out of the trust or the trustees conduct arrangements that result in a reduction in the value of the trust assets.

There are other types of trusts that are specially defined trusts that are in neither category above. For example:

- Temporary charitable trusts
- Trusts for bereaved minors
- Age 18-to-25 trusts
- Trusts for the benefits of employees

B. Income Tax – UK resident trusts

Much like Inheritance Tax, the current taxation of income arising to a trust differs depending on the type of trust. However, the categories of trust are not the same, reflecting the different nature of income and drivers to secure tax revenue:

- *Trusts where beneficiary entitled to income* – These are trusts where a beneficiary has an absolute right to trust income.

  Where the trustees receive the trust income that arises they are chargeable to Income Tax on that income at the basic rate (20%) or dividend ordinary rate (7.5%). However, because the beneficiary is entitled to the income, the beneficiary is also taxable on the income based on their individual tax rates and allowances. To prevent double taxation, the beneficiary is given a credit for the tax paid by the trustees on the same income.

- *Discretionary and accumulation trusts* – These are trusts where the trustees have a discretion over income and/or a power to accumulate it.

  Income that arises to these trusts is taxed on the trustees. The first £1,000 of income is taxed at 7.5% to the extent that it is dividend income and at 20% on other income; and income over the first £1,000 is taxed at the special trust rates (38.1% on dividend income and 45% on other income). Where the trust is a vulnerable beneficiary trust, special rules allow the amount of Income Tax to be relieved to the amount that would been payable if the income had arisen to the beneficiary.

  A separate 'tax pool' mechanism operates in relation to any payments made at the trustees' discretion from income. Broadly, the mechanism treats the payments as being made with a 45% tax credit, which the beneficiary uses against their own tax liability on the distributed income. The tax pool then works to ensure that overall the trustees have paid enough tax to cover the tax credits year on year. Tax paid by the trustees on income goes into the tax pool, and this is then reduced by the amount of the tax credits accompanying the distributed income payments. Where the trustees have not paid sufficient tax into the pool to cover the tax credits (for example because tax was paid at a lower rate), they must pay the difference to HMRC.

- *Trusts where income is treated as that of the settlor* – To prevent avoidance, Income Tax rules treat the income arising to a trust in certain circumstances as income of the settlor. Those are where:

  - the settlor has an interest – this may be because the settlor can or may benefit from the trust, whether from the income or underlying capital, or the settlor's spouse or civil partner can or may benefit from the income or the underlying capital.

  - income is paid to a child of the settlor and the child is under the age of 18 and neither married nor in a civil partnership.

To prevent double taxation, the settlor obtains a credit for the tax paid by the trustees. Where an amount of tax remains payable in relation to the income, the settlor may obtain funds to pay the tax from the trustees. Conversely, where the credit results in a repayment of tax from HMRC it must be paid to the trustees. In this way the trust suffers only the tax payable by the settlor.

If the trust is discretionary, any payments to the settlor are taken out of charge. Payments to a beneficiary other than the settlor are treated as having paid tax and the beneficiary receives a tax credit to ensure that they have no further liability. This tax credit is ring-fenced so that no part of it can be repaid or set against a liability arising from any other income of the beneficiary.

Where the trust is one where a beneficiary is entitled to the income and it is received by that person, the income is treated as that of the settlor alone and there is no charge on the actual beneficiary. This does not prevent a charge on the trustees if they receive the income.

C. Capital Gains Tax (CGT)

If the trust is bare the trustees are ignored and the relevant beneficiaries are treated as if they had carried out the particular transactions themselves.

Otherwise, trustees are liable for Capital Gains Tax on chargeable gains that accrue to them.

Unlike for individuals, the rate of tax that applies is unaffected by the level of taxable income that arises to the trust; the highest rate applicable to the asset disposed of applies (28% on residential property gains and 20% on other chargeable gains) subject to any reliefs available. Trustees are entitled to an annual exempt amount of half that allowed to individuals and the treatment of losses for trustees is the same as that for individuals. For vulnerable beneficiary trusts, special rules allow the gains to be taxed according the circumstances of the beneficiary.

D. Offshore Trusts

Anti-avoidance rules ensure it is not possible to use offshore trusts to shelter overseas income, gains or assets from UK tax. Offshore trusts are liable to tax on UK source income in the same way as for UK resident trusts. UK resident beneficiaries of offshore trusts are liable to UK tax on any income distributions that they may receive from offshore trusts.

If the offshore trust is settlor-interested then the trust income is treated as that of the settlor if the settlor is UK resident and UK domiciled. There are also special rules that can apply to non-domiciled and deemed domiciled settlors of offshore trusts who are resident in the UK.

Where assets are transferred abroad, legislation can also apply to assess the settlor of an offshore trust on the income arising in the trust or its underlying entities if the settlor has the power to enjoy the income of the structure or receives or is entitled to receive a capital sum arising from the transfer.

For Capital Gains Tax, offshore trusts are liable to tax on gains accruing on the disposal of UK residential property; and from April 2019, all gains accruing on UK immovable property disposals will be subject to a new payment on account system.

For gains that are not taxed on the trustees, they may be attributed to liable UK domiciled (including deemed domiciled) and resident settlors; or, if there is no such person, UK beneficiaries when they receive directly or indirectly a capital payment to the extent that it is matched to trustees' gains. A person may also be liable to CGT when gains arise to relevant overseas private companies in which the trustees have invested.