The Taxation of Trusts: A Review

Consultation Response: Wedlake Bell LLP

Wedlake Bell LLP is a central London law firm over 200 years old. It has 69 partners and is one of the top 100 firms in the UK on turnover[1].

The firm welcomes the opportunity to respond to H M Revenue & Customs' consultation document, "The Taxation of Trusts: A Review" dated 7 November 2018 ("**the Consultation Document**").

Wedlake Bell's response has been prepared by its Private Client team and is limited to those questions in the Consultation Document that it feels are most important to its client base.

Wedlake Bell's Private Client team has extensive experience of setting up and advising on trusts, administering trusts and estates, and acting for parties involved in contentious trust and probate claims. The size of trust or estate the team usually administers and/ or advises on would generally range from £1million to £20million.

Wedlake Bell's Private Client team is ranked in the Legal 500 2017 (tier 3), was a finalist in the Society of Trust and Estate Practitioners (STEP) Private Client Awards 2018 for Private Client Legal Team of the Year (mid-size firm) and was instrumental in Wedlake Bell's award of "Law Firm of the Year – London" in the Citywealth Magic Circle Awards 2018.

Executive Summary

A summary of the main points detailed in our responses is set out below.

- The existing UK legislation goes far enough in respect of trust transparency. Caution is needed in extending this still further at the expense of privacy and personal safety.
- The 20% inheritance tax ("**IHT**") lifetime chargeable transfer charge is not tax neutral when compared with outright transfers of assets.
- It is not fair or neutral for Will trusts to suffer a 40% IHT charge at commencement followed by further IHT charges every ten years.
- The IHT treatment of interest in possession trusts should be reassessed and simplified, if possible into a single regime across all lifetime and Will interest in possession trusts.
- We disagree that capital gains tax private residence relief in the context of trusts produces a non-neutral outcome and requires assessment.
- The current ability for trustees to deduct trust management expenses is justified particularly in view of trustees' higher rates of income tax and lack of personal allowance.
- The IHT qualifying conditions for bereaved minors' trusts should be more flexible to allow more children to benefit without needing to become entitled to assets at age 18.
- The qualifying conditions for disabled person's trusts should also be reassessed from a flexibility perspective to encourage more parents to set up such trusts for a disabled child.
- The IHT residence nil-rate band regime is unnecessarily complex, discriminatory and requires review so that more people can understand and benefit from the regime.

Consultation Question 2

There is already significant activity under way in relation to trust transparency. However, the government seeks views and evidence on whether there are other measures it could take to enhance transparency still further.

[1] The Lawyer's top 200 UK law firms 2018 by revenue (ranking: 83).

The UK legislation implementing the Foreign Account Tax Compliance Act ("**FATCA**"), the Common Reporting Standard ("**CRS**"), the persons with significant control ("**PSC**") regime and the UK trust register have already introduced significant and far-reaching transparency requirements. We believe this existing legislation is sufficient in relation to trust transparency without further measures (other than those already announced) to enhance this still further. Any further steps risk further infringing the privacy rights of trustees, beneficiaries and settlors, and in some cases jeopardising their personal safety.

We already have concerns about the widening of the trust register requirements in accordance with the EU Fifth Anti-Money Laundering Directive and in particular the proposal that the trust register be available to those with a "legitimate interest". Article 8 of the Human Rights Act 1998 (the right to respect for privacy and family life) provides strong and legitimate reasons why details about trustees, beneficiaries and settlors should not be made available to the general public. The need to respect the privacy and personal safety of individuals should be given proper weight in the global strive for transparency. We look forward to the government's consultation on the implementation of the Fifth Anti-Money Laundering Directive and hope that a fair balance between transparency and privacy can be struck.

We would raise that the existing legislation perhaps goes further than is 'fair'. Trust disclosure is required of a wide category of beneficiaries regardless of the size of their interest in the trust fund. However, the PSC register for companies uses "significant control" to define which shareholders" details must be disclosed (broadly, those with a 25% shareholding). There is no similar percentage definition for trusts implying that it is the government's aim for trusts to be more transparent than companies, which does not seem fair or proportionate.

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.

We do not have clients who are UK resident and domiciled wanting to set up a non-resident trust. Whilst this may have been the case in the past when the tax rules were less neutral, the use of trusts by this category of person has, in our experience, been phased out as a result of the changes to the taxation of non-resident trusts over the past eighteen years, most recently with the Finance (No. 2) Act 2017.

It remains true that a non-resident trust can have the slight tax advantage of deferring a capital gains tax charge (where gains are not taxed on the settlor) as gains made by non-resident trustees are not generally immediately chargeable to capital gains tax (although they will be brought into charge when a capital payment representing those gains is made to a UK resident beneficiary); however, in our experience, this is not reason enough for UK resident and domiciled settlors to want to set up a non-resident trust.

The cost of setting up and administering a non-resident trust (as an offshore trust company is nearly always required to act as trustee) is such that non-resident trusts are not worthwhile for UK resident and domiciled settlors when they offer no (or very limited) advantages from a UK tax perspective.

Consultation 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.

It does not support the government's stated aim of tax neutrality to impose a 20% IHT lifetime chargeable transfer charge on individuals who set up a trust during their lifetimes where the value of that transfer exceeds their available nil-rate band (currently a maximum of £325,000). As acknowledged in the Consultation Document, individuals who make outright gifts of assets during their lifetimes are not subject to such an upfront charge and a restriction on the amount that they can gift free of IHT. If tax neutrality as between these two scenarios is genuinely sought, settlors should be free to gift any amount when setting up a trust, in the same way as they can gift outright, subject to them surviving the date of commencement of the trust by seven years, failing which, the transfer into trust would be chargeable on death at the rate of 40% (subject to their available nil-rate band).

We recognise that the 20% IHT lifetime chargeable transfer charge is designed, when aggregated with three ten year charges of 6%, to roughly equate to the 40% charge on death so that this produces a near-neutral outcome over a generational period of 30 years when compared with an outright gift of the same assets. However, this assumes that, in an outright gift scenario, the recipient is still holding those assets at death. The recipient is free to give away those assets him/herself to the next generation during their lifetime and, indeed, this is sensible and common estate planning. Therefore, in an outright gift scenario, the 40% IHT charge at death can be fairly easily and legitimately prevented from one generation to the next. This is not so with trusts. Trusts must continue to pay the ten year charge of 6%, generation after generation, during the trust's existence; meaning that, over the course of a lifetime of a trust of 125 years, the trustees will pay total IHT charges of up to broadly 95% (the 20% upfront charge plus twelve ten year charges and an exit charge on termination of approximately 3%). If the same assets had been gifted outright by the settlor, it is quite feasible with careful estate planning, for the total IHT charges over this period to be nil.

On top of the IHT charges paid by trusts over the course of the trust's lifetime, trusts pay income tax at a higher rate than the average individual. With the exception of those trusts where income is assessed on the life tenant or other relevant beneficiary, trustees are subject to income tax at the trust rate of 45% (subject to the first £200-£1,000 of income being taxed at basic rates). Although individuals with incomes in excess of £150,000 are subject to income tax at the same rate, they potentially have the benefit of their personal allowance (currently £11,850) to which trustees are not entitled. Trusts will therefore generally pay far more income tax than an individual who receives the same assets in an outright gift scenario.

There is also the compliance cost of running a trust which needs to be factored in. Due to the complexity of the trust taxation regime and transparency initiatives such as the Common Reporting Standard and the Trust Register - accountancy, legal and /or financial advice is nearly always required which will be a cost burden on the trust and particularly problematic if the trust is a "dry" one without the liquid assets to pay such charges.

For all of the above reasons demonstrating the tax and cost burden on trusts, we therefore do not consider that lifting the 20% IHT lifetime chargeable transfer charge would be unfair when compared with an outright gift scenario. It is accepted that trusts offer the advantage of asset protection over that of an outright gift, and the 6% ten year charge might be a fair price for that protection; but the balance of fairness is tipped when you factor in the 20% upfront charge as well.

Separately, the Consultation Document mentions Will trusts at paragraph 5.5.3 and how these are generally subject to the 40% IHT charge at death followed by the 6% ten yearly charges. This does not seem fair or neutral as compared with outright ownership, or indeed a lifetime trust. If the assets passed outright at death, they are subject to the 40% charge on death, but not the ongoing 6% charges. Similarly, although lifetime trusts suffer the 6% charges, the settlor pays a 20% IHT charge at creation, not 40%. It therefore does not seem to support the government's stated aim of fairness for Will trusts to bear the 40% charge at commencement followed by ten yearly charges, meaning that during the first 30 years of the Will trust, the assets could be subject to IHT at a total rate of 58%. This is far higher than the

intended 40% charge per generation. We would propose that Will trusts that are subject to the 40% IHT charge on death be subject to a reduced ten yearly charge for the first 30 years of the Will trust's existence with the charge being set at a low level (we would suggest between 1% and 3%) which acknowledges that the assets are benefitting from greater protection and estate planning flexibility than they would if they were on outright ownership, but does not penalise such trusts with a 6% charge ever ten years.

A further point made at paragraph 5.5.3 is that the range of Will trusts that are treated for IHT purposes as part of the beneficiary's estate is wider than lifetime trusts. Specifically, it is possible to create an interest in possession trust on death that qualifies as an immediate post-death interest ("**IPDI**") trust under s.49(1) and 49A Inheritance Tax Act 1984, meaning that the underlying assets are subject to IHT as if owned by the life tenant. An interest in possession trust created during lifetime is subject to the IHT relevant property regime. We therefore have two separate IHT regimes for interest in possession trusts as from 22 March 2006. We also have pre-22 March 2006 lifetime interest in possession trusts which are taxed under s.49 Inheritance Tax Act 1984 as if the underlying assets were owned by the life tenant. This produces a very complex web of regimes for interest in possession trusts and does not support the aim of simplicity in trust taxation. In the interests of simplifying the IHT regime, it would seem reasonable to have a single regime. Taxing the underlying assets as part of the life tenant's estate is a logical system and easy for settlors to understand but we appreciate that imposing this regime on all interest in possession trusts, whether created on lifetime or on death, would reverse a significant part of the reforms that were made to IHT treatment of trusts in Finance Act 2006 and may not be feasible.

Consultation Question 7

The government seeks views and evidence on:

a) the case for an against targeted reform in relation to any of the possible exceptions to the principle of fairness and neutrality detailed at paragraph 5.6; and

b) any other areas of trust taxation not mentioned there that would benefit from reform in line with the fairness and neutrality principle.

In relation to capital gains tax private residence relief, it is discussed at paragraph 5.6.1. that it does not produce a "neutral" outcome to allow trustees to claim private residence relief on a property occupied by a beneficiary because the proceeds of sale might be applied to benefit beneficiaries other than the life tenant who occupies the property as their main residence. However, an outright owner is similarly free to apply the proceeds of sale from their main residence to benefit other people (she or he could gift the proceeds away, for example), so we are not clear that there is a difference that needs addressing here. No-one can have more than one main residence at any one time for the purposes of this relief in any event, so there can be no question of the life tenant (or any of the beneficiaries to whom the proceeds could in theory be applied) benefitting from "double" relief. We therefore do not need believe that private residence relief needs any amendment in this context.

In relation to Trust Management Expenses, as discussed at paragraph 5.6.2., it is noted that trustees are able to deduct expenses incurred exclusively in relation to trust income, such as their costs in preparing the trust's income tax return, from the trust's taxable income, and this is more generous treatment than for individuals. However, we would point out that the differences between trusts and individuals warrant this different treatment. Most trusts pay income tax at the Trust Rate of 45% without the benefit of deducting a personal allowance from their overall income in the same way that individuals can. Trustees also have to bear a range of costs that individuals do not. Compliance for trusts has significantly increased in recent years with the introduction of FATCA, the CRS, the trust register, the PSC regime

under the Companies Act 2006 and the Legal Entity Identifier codes required by the London Stock Exchange. All of these regimes have increased the professional costs that trustees need to pay to lawyers, accountants and investment managers so that they can ensure their trust is compliant. This in on top of the standard administration costs associated with running the trust; most trusts will need to engage a lawyer and accountant to assist the trustees with preparing deeds and documents in connection with any exercise of their powers and with preparing the trust's tax return. Whilst some of these costs can be deducted from the trust's taxable income, the vast majority cannot. These costs already eat in to the income that is available for distribution to the beneficiaries, without individuals suffering the same deductions. We therefore believe that keeping the trustees' income tax liabilities to a minimum by allowing them to make use of tax deductions is fair and justified. Without these, the amount of income that can be passed on to beneficiaries could be significantly depleted, and in many cases would prove a real disincentive for many settlors to set up and use trusts for the genuine and legitimate reasons set out in paragraph 2 of the Consultation Document.

Consultation 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.

We note and welcome the comments made at paragraphs 6.4. and 6.5 that the government is committed to taking action to simplify the treatment of trusts for bereaved minors and trusts for disabled beneficiaries ("**Vulnerable Beneficiary Trusts**") particularly in relation to income tax and capital gains tax.

We would comment generally that, in our experience, clients do not want to set up bereaved minor trusts or "18 to 25" trusts in their Will and we have had very little take-up for them. Clients generally do not want their children to become entitled to trust assets at age 18, or indeed 25, and prefer the flexibility of a discretionary trust so that the trustees can control at what age the child benefits as this will vary depending on the child and the circumstances. This is sad as this flexibility comes at a price in tax terms as the trustees must of course then pay the IHT relevant property regime charges and are subject to the more onerous and complex income tax regime for trusts.

The will to create trusts for minor children and young adults is still very much there for virtually all of our clients and in the interests of fairness we would prefer to see reforms that create more realistic options for parents who want to settle assets for their children for valid asset protection and management reasons, without them needing to accept high tax charges as a price for that protection. Inheriting assets at age 18 will rarely (if ever) be appropriate for any of our clients and whilst we appreciate that their level of wealth has a significant bearing on this (the value of our clients' estates is generally at least £1million), the same point would apply to trusts for less wealthy individuals: children are rarely mature enough at age 18 to be responsible for any level of asset that needs managing financially. We would favour a return to age 25 as the cut-off age, at least for income tax and capital gains tax purposes, with the trust benefitting from tax treatment which ensures the trustees pay no more than the tax that the child would have paid if she or he had received the income and gains directly. This would avoid the complicated tax pool mechanism and the need for the child to effectively claim back the tax that the trustees have paid as currently needs to happen under the existing age 18-25 trust regime. From the perspective of appointments of trust capital and the IHT regime, in line with our comments on question 6 above, we do not think that the trust should suffer full exit charges for the first 30 years of the trust's existence to take into account that the assets will have been subject to the 40% IHT charge on death. We would suggest a lower level of charge – perhaps set at between 1% and 3% to take into account the benefits that a trust brings in comparison with outright ownership.

In relation to disabled person's trusts under s.89-89B Inheritance Tax Act 1984, again we have had very little take-up of these mainly due to their inflexibility and the need to comply with the condition that if any property is applied during the disabled person's life for the benefit of a beneficiary, it must be applied for the benefit of the disabled person. A discretionary trust is far more attractive to the parents in terms of flexibility particularly where they have more than one child, but as above, this flexibility currently comes at a price in tax terms. We would welcome a review of the qualifying criteria for disabled person's trusts to provide for greater flexibility.

Consultation 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.

We would like to comment on the residence nil-rate band ("**RNRB**"). Whilst the introduction of an effective extension to the standard nil-rate band is welcome and long-awaited given the freeze on the standard nil-rate band since 6 April 2009, the way in which the relief is structured is hugely complex and difficult for tax-payers to understand; consequently preventing tax-payers from making effective use of it.

Some of the complex elements of the RNRB are set out below.

Many clients are unaware that eligibility for the relief depends on to whom the family home passes (lineal descendants only), as this is not how the standard nil-rate band operates. It is also a discriminatory aspect of the relief and on which we comment further below.

The restriction of the relief to gifts on death and not gifts during lifetime is an unfair aspect of the relief. The standard nil-rate band applies to lifetime gifts and is "refreshed" every seven years. Clients find this disparity difficult to understand and take into account in their estate planning. It is possible that tax-payers who have not taken professional advice, but relying on how the RNRB has been reported in the press as "an additional IHT relief for the family home", are carrying out planning with the family home during their lifetimes in reliance on the RNRB applying to the gift.

The definition of "inherited" and its restriction to absolute gifts, certain (but not all) gifts on trust and the anomaly that lifetime "gifts with reservation" can qualify under the RNRB rules is an unnecessary complex aspect of the relief. Many clients' Wills that were drafted prior to the RNRB being introduced will not qualify without amendment. We comment more on this below.

The interaction of the RNRB with IPDIs and lifetime qualifying interests in possession ("**QIIP**") under s.49 Inheritance Tax Act 1984 causes problems. Whilst a property that is held in such a trust can qualify under s.8J(5) Inheritance Tax Act 1984 for the RNRB on the life tenant's death (provided it is a qualifying residential interest under s.8H Inheritance Tax Act 1984 and it is "inherited" by lineal descendants on the death of the life tenant), most IPDI and QIIPs will contain overriding powers of appointment allowing the trustees to appoint all or part of the trust fund (including the property) to selected beneficiaries during the life tenant's lifetime or on death. The existence of these powers, even if not used by the trustees, prevents the remainder interests from qualifying as "inheriting" the property for the purposes of the RNRB even if the property passes to those remaindermen absolutely on the life tenant's death. This is because the remaindermen are not regarded as absolutely beneficially entitled as the overriding powers could be used to defeat their interest at any time. In reality, this means that the trustees need to be aware of this trap, take and pay for legal advice on it, and execute a deed to release their overriding powers during the life tenant's lifetime so as to allow the remainder interests to qualify for the RNRB. We believe this is an unfair and overly complex state of affairs, causing the trustees to spend time and money rectifying the issue (if, indeed, they are aware of the issue at all), and will waste HMRC's valuable

time and resources in dealing with resulting queries from trustees on it. Unless it is felt that legislation is needed, it would be helpful if HMRC could issue guidance to confirm that they will not treat the existence of overriding powers as preventing the remainderman from "inheriting" a qualifying residential interest for the purposes of the RNRB.

The calculation of the RNRB which involves assessing the "residential enhancement", "brought-forward allowance", "default allowance" and applying the taper threshold is hugely complicated. It is likely that many lay tax-payers will need professional advice to comprehend the calculation, or will need to seek advice from HMRC which will inevitably take up HMRC's valuable time and resources.

The calculation of the "downsizing addition" adds a further layer of complexity and is in our experience nearly always impossible for a lay tax-payer to understand and calculate without professional advice, or recourse to HMRC.

The way in which the RNRB is limited to lineal descendants is discriminatory to those without children. The standard nil-rate band is not similarly restricted. We can see no fair policy justification for limiting the relief to those who can or want to have a family. The qualification should attach to the residence that you own at death (or have downsized before death) without any restriction on to whom this passes.

The introduction of the RNRB has been used by the government to justify a continued freeze since 2009 on the standard nil-rate band at £325,000. However, those without children who are unable to benefit from the RNRB, are therefore limited to £325,000 IHT relief which, when the average price of property in London is £471,944 and the South-East £320,682[2], means that a greater proportion of the estate is unfairly pushed above the nil-rate threshold and subject to IHT. A simple and straightforward increase in the standard nil-rate band to take into account, at least to some extent, inflation since 2009, would benefit everyone.

The taper threshold of £2million encourages those on the cusp of this amount to actively embark on tax planning in order to reduce their estates below the threshold. Whilst such tax planning is legitimate if done within the boundaries of the UK's tax avoidance regimes; if professional advice is not sought, there could be tax avoidance issues that may go undiscovered by HMRC. Similarly, a taper threshold which puts pressure on taxpayers to give away assets can lead to elderly tax-payers being coerced into making gifts that they do not want, or may not have the capacity, to make. Instances of elder financial abuse could accordingly increase.

Advice on the RNRB can be particularly complicated where, due to the taper threshold, spouses/ civil partners need to structure their Wills to make use of the relief on the first death if the combined estate will exceed the threshold but a single estate will not. Making use of the relief in this scenario could introduce a potential conflict situation between executors/ trustees, the surviving spouse/ civil partner and children, particularly in second marriage situations, as the interests of the survivor and children may not be aligned (the children wanting the relief to be utilised, and the survivor preferring to keep ownership of the property at the expense of the relief). This increases the likelihood of litigation and family conflict, and potentially puts executors/ trustees in a very difficult position where they are forced to choose between the two sides. Some executors/ trustees may decide that they cannot continue in the role as a result.

The result of the complex way in which the relief has been structured is that clients do not understand the rules. Many assume that because they own a property, they will be entitled to the relief automatically and do not take any action to amend their Will. However, if the Will does not include a qualifying gift to children, the relief will be lost. This might be the case, for example, if the children inherit with contingent interests, or under a discretionary trust and the executors/ trustees do not take professional advice about using the "writing-back" effects of s.144 Inheritance Tax Act 1984. Other clients do take advice, but the

[2] From UK House Price Index summary: March 2018 (published 23 May 2018).

time needed to explain the complexities of the relief and the way in which it impacts the decisions they make about their Will and estate planning, means that professional fees for preparing a Will will surely have increased for those clients affected since the introduction of the RNRB. This could have the result of discouraging clients to make a Will, or to seek advice on the RNRB.

Whilst we appreciate that the RNRB rules are still in their infancy, having only been introduced in April 2017, and making amendments to the rules so soon would usually be avoided, we are of the opinion that the need for simplification and fairness outweighs the need for continuity in this situation. Making an increase in the standard nil-rate band would be far more straightforward for tax-payers to understand, and HMRC to assess and deal with, than the present system. If this cannot be accommodated, at minimum we would suggest that the RNRB rules are amended to remove the discriminatory requirement for lineal descendants to inherit.

Wedlake Bell LLP

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