

THE QUEST FOR FAIR INHERITANCE TAXATION OF TRUSTS

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CONTENTS

The IHT background	1
Requirements of a satisfactory system of trust taxation: the equality criteria	3
Does IHT meet the trusts equality criteria?.....	4
How did we reach where we are now?	5
Why did we reach where we are now?	5
The way ahead	7
<i>Inheritance taxation of gifts to trusts</i>	<i>7</i>
<i>Inheritance taxation of trust property</i>	<i>7</i>
Postscript	9

The IHT background

- 1 Proposals for the reform of inheritance taxation of trusts can only be considered in the wider context of inheritance tax.
- 2 Inheritance tax generally (not just inheritance taxation of trusts) is a topic on which:
 - 2.1 Views differ considerably
 - 2.2 Views are often strongly held and sometimes passionately held.
- 3 IHT links (or seems to link) to deep issues concerning redistribution/confiscation, equality, and the role of private property in society.
- 4 Views for reform include:
 - 4.1 Abolition, eg the Forsyth Report.¹
 - 4.2 Extension:
 - 4.2.1. to lifetime gifts (reverting to CTT)
 - 4.2.2. Restriction on 100% business and agricultural property reliefs
 - 4.2.3. Progressive rates of IHT

¹ Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission (October 2006)
<http://www.conservatives.com/pdf/taxreformcommissionreport.pdf>

- 4.2.4. Abolition of CGT tax free uplift on death (recommended by Mirrlees review)
- 4.3 Recasting: Donee rather than donor basis of assessment.
- 5 International practice differs dramatically.
- 6 IHT is a tax with many opportunities for avoidance/mitigation of which
 - 6.1 lifetime gifts and
 - 6.2 100% agricultural/business property relief
 are only the most obvious.
- 7 Very considerable resources go into IHT mitigation/avoidance.
- 8 Mirrlees describes IHT as:
 - 8.1 “a half-hearted tax”
 - 8.2 “subject to charges of unfairness”
 - 8.3 “a principled defence of the current IHT is difficult”
 - 8.4 “Does not stack up well against any reasonable set of principles for the design of a tax on inherited wealth”.
 - 8.5 “Something of a mess”.
 - 8.6 “Falls disproportionately on the middle classes to the benefit of the rich”.
 (Mirrlees 2011 para 15.1; 15.4; Mirrlees 2010 p.748.)
- 9 IHT is the only tax in the UK that around half the population believes should be abolished (Mirrlees 2011 para 15.3). Why? Some of the answers offered seen somewhat inadequate:
 - 9.1 Although only 6% of estates pay IHT, 37% of households have an estate above the threshold (Mirrlees 2010 p.746). No doubt many more expect or hope to do so by the time they die.
 - 9.2 IHT is more visible than IT or VAT? (This suggestion is somewhat patronising to those opposed to IHT).
 - 9.3 A perception of double taxation (IT on receipt of income and IHT on giving it away.)
- 10 Would-be IHT reformers should note:
 - 10.1 IHT does not raise a significant amount of tax (measured as a percentage of total tax receipts – less than 0.5% in 2009/10: Mirrlees 2011 para 15.3). That is not likely to change, given that none of the G7 economies have raised more than 1.0% of national revenue from estate, inheritance and gift taxes in any year over the last forty years. (Mirrlees 2010 para 8.1).
 - 10.2 It may only be because of these features that IHT survives at all, as they weaken the lobby for abolition of the tax: contrast the American experience: Graetz & Shapiro, *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth* (2005).

- 11 It is reasonable to expect anyone commenting on reform to disclose where they stand on the above issues. I agree with Mirrlees that a satisfactory CTT would be better than IHT if it were possible; but in my view, experience shows that a satisfactory CTT is not possible; and abolition would be much better than what we have now.
- 12 In particular abolition of IHT would facilitate improvement of CGT:
- 12.1 Abolition of the CGT uplift on death.
- 12.2 A gift to a discretionary trust would be a PET, so one could also repeal hold-over relief on gift to discretionary trusts.
- 13 This illustrates an important point about capital taxation reform. The repeal of IHT makes possible an extension of CGT which at present is limited by the desire to avoid double taxation - in the form of CGT & IHT charged on the same event. This mitigates the cost of repeal – it may be revenue raising.
- 14 Countries in which an IHT has been abolished include the Canadian and Australian jurisdictions.

Requirements of a satisfactory system of trust taxation: the equality criteria

- 15 In the UK:

“The government recognises the important role trusts play in society and has said that as far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust, but equally avoids artificial obstacles to the use of trusts where their use would bring significant non-tax benefits.”²

- 16 Quite so. Similarly in Australia:

"The Government considers that, where used appropriately, trusts are a legitimate structure through which Australians should be able to conduct their personal and business affairs — not a form of tax avoidance."³

- 17 I refer to this as **“the trusts equality criteria”**.

- 18 This is looking at the matter from the position of settlors and beneficiaries. However there is also a public aspect. Under a trust, it

² “Modernising the Tax System for Trusts” HMRC, 17 December 2004.

³ Modernising the taxation of trust income — options for reform Consultation Paper November 2011
http://www.treasury.gov.au/documents/2215/PDF/Consultation_Paper_Modernising_Taxation.pdf.

will normally be the case that one or more trustees with no personal interest in the trust have responsibility for paying tax. This offers an advantageous system for tax collection in that there is a neutral party who has a duty to the Crown. Standards of compliance are generally higher in relation to trust property than other property. Mark Herbert QC makes the same point in his lecture quoting Robert (now Lord) Walker:

Trustees are the PAYE-gatherers of capital taxation, with no personal financial interest in avoiding the taxes for which they are personally liable, and the very high degree of compliance with the system must owe a lot to their conscientiousness. If settlements are discouraged by discriminatory legislation, unlawful evasion of tax must be expected to increase.⁴

Does IHT meet the trusts equality criteria?

- 19 There is a disparity between trusts and individuals in that:
 - 19.1 A gift to an individual is a PET (tax free if the donor survives 7 years).
 - 19.2 A gift to a trust is a chargeable transfer.

- 20 There is a further disparity in that:
 - 20.1 An individual's property is subject to tax on his death (subject to the spouse exemption).
 - 20.2 Trust property is subject to 10 year and exit charges, which amount (over a lifetime) to a much more onerous regime.⁵

- 21 The result that:
 - 21.1 In most cases lifetime trusts will not be created. Trusts are valuable to settlors and their beneficiaries, but not usually *that* valuable.
 - 21.2 In most cases, where privileged trusts are created by will, they will be wound up relatively soon:
 - 21.2.1. IPDI trusts will generally be wound up on the death of the life tenant.⁶
 - 21.2.2. Bereaved Minors trusts and Age 18-to-25 trusts (which in practice are only rarely made) will be wound up when the beneficiaries reach 18 or (I suspect less often) 25.

⁴ Walker, "The Reform of Capital Transfer Tax — Better the Devil You Know" [1986] BTR 143.

⁵ It may be suggested that IHT trust charges of up to 6% each 10 years are less onerous than lifetime charges of up to 40% once a generation. But the IHT trust charges are paid sooner, and have no gift exemption and no spouse exemption, so their burden is unquestionably much greater.

⁶ In particular, a gift to another individual may qualify for the spouse/civil partner exemption: the termination of an IPDI will not usually do so unless the trust then comes to an end.

- 21.3 For completeness: Exceptional cases where trusts are created and maintained under the present regime are:
 - 21.3.1. Trusts within the nil rate band.
 - 21.3.2. Property qualifying for 100% Business/agricultural property relief (if one is prepared to assume the reliefs will continue).
 - 21.3.3. Foreign domiciled settlors.
- 22 Thus the Inheritance Taxation of trusts markedly fails the trusts equality criteria.
- 23 What are donors doing instead?
 - 23.1 Family Partnerships?
 - 23.2 Company shares?
 - 23.3 Bare trusts
 - 23.4 Absolute gifts
 - 23.5 Loans
 - 23.6 Waiting for times to improve

There is a social cost in that the benefits of trusts are not currently available to the public.

How did we reach where we are now?

- 24 Until 2006 the Inheritance Taxation of trusts (more or less) met the equality criteria. The changes were made in the FA 2006.

Why did we reach where we are now?

- 25 It is not possible to tell what was the motive of the 2006 reforms or indeed whether they had clearly thought out motive(s):
 - “There seems no considered policy on the taxation of wealth transfers behind this change.” Mirrlees 2010 p.752.
- 26 Having decided on a reform one naturally tends to put forward all possible arguments in support.
- 27 One is naturally tempted put forward bad arguments in support as well. “Laws, like sausages, cease to inspire respect in proportion as we know how they are made.” (John Godfrey Saxe, misattributed to Bismarck).

28 Erroneous arguments propounded by those putting through the new law (which the proponents themselves may or may not have believed) include the following:

28.1 The changes “aligned” the formerly “privileged” tax treatment of IP and A&M trusts with the “normal” “mainstream” tax regime for discretionary trusts.⁷ In fact, substantial discretionary trusts, i.e. those paying any substantial IHT, were exceptional.⁸

28.2 The changes would only raise £15m per year.

28.3 Only a very small number of very rich people, quantified as 20,000, would be affected.

28.4 The new rules had been supported by professional bodies in prior consultation.

28.5 The new rules offer a “modicum of simplification”.⁹

29 The Select Committee on Treasury concluded:

With respect to the new rules on the tax treatment of accumulation and maintenance and interest in possession trusts, we are concerned that estimates of the expected numbers of affected trusts vary so widely between Government and practitioners. If the Government’s estimate, that the new rules will affect “only a very small number of very wealthy people” is correct, then the Government needs to provide much more detailed information about its estimates, in order to allay taxpayer and industry concerns. We are concerned that a legitimate measure designed to reduce tax avoidance may penalise trusts established to protect family members and consider that the issue merits further consideration. We recommend that the Government provide detailed information about how it has arrived at its estimate that the new rules on the tax treatment of certain trusts will affect only “a minority of a minority” of 100,000 discretionary trusts. This information should be provided

⁷ Standing Committee debate, 13 June 2006, HC Official Report, col. 569, 570, 633 (Dawn Primarolo).

⁸ There was a good reason for this. The discretionary trust regime was designed in 1982 to impose on discretionary trusts a burden roughly equal to the burden of *capital transfer tax* on non-settled property. It achieved that. In 1986, CTT was then replaced by the much lighter IHT regime, under which tax was no longer charged on lifetime gifts. There is no obvious solution as to how to deal with discretionary trusts under an IHT regime. The solution adopted was to retain the old CTT rules, which then imposed a burden on discretionary trusts rather greater than that which applied to non-settled property, but allowing the alternative route of IP trusts (and A&M trusts) which were, broadly, treated in the same way as non-settled property. Thus the charges on discretionary trusts had something of the nature of anti-avoidance provisions. Although the tax charge could be unduly high, that did not matter because nobody needed to pay it, and almost no-one actually did.

⁹ Standing committee debate, col. 605 (Dawn Primarolo).

prior to consideration in Committee of the House of Commons of Clause 57 of, and Schedule 20 to, the Finance Bill.¹⁰

- 30 No such evidence was ever produced.
- 31 Some semi-official acknowledgement of this failure has come from Dave Hartnett:

Looking in another direction, the confusion and difficulties caused by tax policy makers when in 2006 reforms of IHT and Trusts were not well formulated. Poor performance ... damaged trust. Trust and transparency are needed to make tax administration work for all stakeholders but they are also a necessary building block for good tax policy.¹¹

The way ahead

- 32 The inheritance taxation of trusts can only be considered in the context of inheritance tax as a whole.
- 33 I make the following proposal on the basis of a reform which will fit into the existing inheritance taxation of trusts. If inheritance tax changed, the inheritance taxation of trusts would also have to change. But this is not the occasion to discuss broader changes to IHT.

Inheritance taxation of gifts to trusts

- 34 All gifts to trusts should in principle¹² be PETs. This taxes trusts on the same basis as gifts to an individual.

Inheritance taxation of trust property

- 35 We should revert to rules which applied 1974 – 2006:
- 35.1 Interest in possession trusts: property in estate of life tenant.
- 35.2 Non-interest in possession trusts: 10 year charge & exit charge regime.
- 35.3 Relief for Accumulation & Maintenance or A&M type trusts.¹³ (The only IHT saving is on the death of a person under 25, which is (actuarially) unlikely so this relief not expensive in IHT terms.)

¹⁰ Select Committee on Treasury Fourth Report, para. 109, accessible www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/994/99402.htm.

¹¹ Hardman Lecture (12 November 2009) accessible <http://www.icaew.com/~media/Files/technical/Tax/Tax%20policy/dave-hartnett-hardman-lecture-influencing-tax-policy-tax-faculty-icaew>

¹² In slightly more detail: As for PETs, the transfer would be exempt to the extent that the transfer is attributable to property which becomes comprised in the estate of another person or trust or to the extent that the value of the estate of another person or trust is increased.

¹³ As under the pre-2006 s.71 IHTA.

- 36 This taxes IP trusts on the same basis as property held by another individual. The FA 1975 approach to equate interests in possession with ownership was correct. It has the following advantages:
- 36.1 Simplicity.
 - 36.2 It allows the spouse exemption on gifts to a trust under which one's spouse has an IP (which even the FA 2006 recognises as fair, in relation to wills);
 - 36.3 It constitutes an IHT trust regime closer to the IHT regime for unsettled property;
 - 36.4 It allows CGT uplift on death.
 - 36.5 It allows double taxation reliefs to operate. Since no-one else in the world has a regime similar to the 10 year charge regime, there is and can be no double tax relief. A tax charge on death of the life tenant fits other regimes and allows relief. This is of current importance, given the EU interest in the subject.¹⁴
- 37 The discretionary trust regime makes sense if it is regarded as an anti-avoidance provision (where there is less need for fairness). There is no obviously better solution, and discretionary trusts need not be created as there are alternatives. Rates would need to come down if it were desired to tax them in line with other types of trusts.
- 38 This reform will not in fact cost any significant IHT. The vast majority of the IHT yield comes from transfers made on death (98% in 2005/06) with very little coming from trusts or taxes on gifts made in the 7 years prior to death: Mirrlees 2010 para 746. It seems safe to say that the bulk of the remaining 2% is failed PETs. Common sense and the author's experience suggest:
- 38.1 Lifetime charges on gifts to trusts only arise where a mistake is made *and* is later identified (as in *Pitt v Holt* [2013] 2 AC 108).
 - 38.2 Discretionary trust charges mainly limited to pre-2006 Accumulation and Maintenance trusts caught out by the FA 2006 reforms.
- 39 My proposal does *not* constitute a particularly effective method of taxing wealth transfers but IHT in its current state does not constitute that. The fundamental problem with the current system is that:
- 39.1 it *is* an effective method of taxing wealth transfers to trusts or via trusts but

¹⁴ http://ec.europa.eu/taxation_customs/taxation/personal_tax/inheritance/index_en.htm

39.2 it is *not* an effective method of taxing wealth transfers otherwise.¹⁵

Postscript

40 The above was written in October 2012. A further harshening of the taxation of discretionary trusts is proposed in 2015.¹⁶ There is again no attempt to achieve a parity of treatment between settled and non-settled property. For trusts:

The broad aim of the relevant property trust charges is to ensure the equivalent of a full IHT charge [ie 40%] is paid on [settled] property once in every generation (30 years).¹⁷

41 Non-settled property does not bear IHT at anything like that rate, even once a lifetime, because of the scope to make gifts and generation-skipping transfers (among other reasons).

42 The proposed reform will restrict all trusts made by one settlor to a single nil rate band and impose “a simple rate of 6%” after that. Then the IHT burden on trust property in excess of the single NRB will greatly exceed the burden on non-trust property. But the door to using lifetime trusts was (more or less) nailed shut in 2006, so this additional change will not make a significant difference. The consultation paper understandably anticipates the exchequer impact to be “negligible”.¹⁸

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References:

Mirrlees 2010 Dimensions of Tax Design

<http://www.ifs.org.uk/mirrleesReview/dimensions>

Mirrlees 2011 Tax by Design

<http://www.ifs.org.uk/mirrleesReview/design>

¹⁵ I do not address transitional issues which would require some further thought, but that is a subsidiary point.

¹⁶ HMRC consultation paper tentidiously entitled “Inheritance tax: A fairer way of calculating trust charges” (2014)
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/317871/140605_Final.pdf

¹⁷ Consultation paper para 2.29.

¹⁸ Consultation paper p.26.