



The Law Society

HMRC consultation: Vulnerable beneficiary trusts

Response of the Law Society of England and Wales

November 2012



THE LAW SOCIETY'S RESPONSE

Introduction

The Law Society is the representative body for over 145,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others. This response has been prepared on behalf of the Law Society by members of its Wills and Equity Committee, which is made up of senior and specialist lawyers practising in this field.

The Law Society welcomes this opportunity to comment on vulnerable beneficiary trusts.

Question 1: Do respondents consider that vulnerable people have distinguishing characteristics outside of the two groups outlined at paragraph 3.3? If so, what are they and why?

The experience of Committee members is that clients set up (or wish to set up) trusts for a variety of beneficiaries who are considered to be 'vulnerable', but who do not fall into the class of orphaned minors or those with a severe physical or mental disability.

For example, trusts are set up to protect an adult child's assets from future spouses and partners. Trusts are set up to protect those who are at risk of giving everything away if 'preyed' upon by the unscrupulous. Trusts are also set up to protect people from themselves, where beneficiaries sadly have severe alcohol or drug dependencies. There are many trusts for beneficiaries who do not have special needs, but are not able to run their own financial affairs. Presently these people, though undoubtedly "vulnerable" are not able to benefit from the special tax treatments enjoyed by vulnerable beneficiary trusts.

This view is mirrored by HMRC's own research on the setting up and management of trusts, referred to on page 10 (Paragraphs 3.3 and 3.4) of the consultation document.

It is obviously hard to accurately quantify the number of trusts set up for vulnerable beneficiaries who are not orphaned minors and do not have a severe disability, as there is no register of trusts. The Committee, however, believes that the use of trusts, and the size of donations to trusts, has decreased since the Finance Act 2006 (FA 2006). Prior to FA 2006, clients wishing to set up trusts to protect vulnerable beneficiaries would have chosen to create a life interest or interest in possession trust. The gift to such a trust was a potentially exempt transfer for inheritance tax ('IHT') purposes, subject to the usual 7-year survivorship rule. The trust assets were aggregated with the life tenant's personal estate for IHT purposes. Tax planning was rarely the primary motivation for setting up such a trust. Rather the trust was intended to provide asset protection for a family that had concerns about the vulnerability of one or more of its members (usually adult children).

Since FA 2006, the same result can be achieved with the use of trusts but subject to the cap on gifts to trust, which have to be within the donor's nil rate band or covered by an IHT exemption (such as business property relief). There is, however, no doubt that many families still have concerns about vulnerable beneficiaries and wish to use trusts to provide for them.

Q2: Do respondents have suggestions for defining a ‘vulnerable person’ for tax purposes other than by reference to orphaned minors and those with a severe physical or mental disability?

We agree that certainty is needed. As set out in the answer to question 3, the current system is complex and puts a burden on clients in the context of self-assessment for tax purposes.

The problem with defining vulnerability is that it is easy to see, but not necessarily easy to describe. One defining quality might be the individual's behaviour, such as an inability to manage their finances in a prudent manner. Such a definition would however be extremely uncertain.

One option would be to let people elect to set up a vulnerable beneficiary trust, irrespective of whether that particular beneficiary is an orphaned minor or has a severe disability. If the results of that election are set out in statute, clients will then be able to decide whether to accept the restrictions that are attached to vulnerable beneficiary trusts (see answers to questions 10 & 11 below). If they decide that such restrictions are not necessary, or would not be welcomed, then they can choose to set up a non-vulnerable beneficiary trust, using their IHT nil rate band and exemptions as appropriate, or simply accept the tax consequences of so doing.

There could be clear links between the advantages of setting up a vulnerable beneficiary trust (e.g. gifts to such a trust are potentially exempt transfers for IHT, not chargeable transfers) and the restrictions that apply to such a trust (see questions 10 & 11). This would negate any need for legislation to define a vulnerable beneficiary trust, by giving taxpayers the choice of whether to elect into the vulnerable beneficiary trust regime.

Trusts for beneficiaries who are orphaned minors or have a severe disability could automatically be trusts for vulnerable beneficiaries, but again taxpayers could also be given an option to elect out of that regime if they wished to do so.

Q3: In relation to those suggestions, what practical issues do respondents envisage in applying them in the context of a self-assessed tax; and how could they be overcome?

The current system of tax reliefs for vulnerable beneficiary trusts is overly complex. For example, there are different provisions that apply to setting up a trust for someone else (who is a vulnerable beneficiary) from those applicable to a self settlement made in the expectation of becoming disabled.

The attached table (Appendix One) indicates the different legislative provisions that apply to vulnerable beneficiaries, as well as the interaction with s32 of the Trustee Act 1925. There are currently different provisions in ss89B(1)(a)–(d) of the Inheritance Tax Act 1984 and Finance Act 2005 ss23 – 41.

As the table shows, there are key differences in relation to:

- the appointment of capital during the beneficiary's lifetime;
- what happens if the beneficiary ceases to be disabled;
- the CGT treatment of the trustees;
- whether there is a CGT uplift on the beneficiary's death;
- the income tax treatment of the trustees; and
- the drafting of the trust instrument.

This complexity adds to the administrative burden for taxpayers, who are expected to account for tax correctly under the self-assessment system. For example, how many lay taxpayers are aware that the vulnerable beneficiary regime in ss23-41 Finance Act 2005 automatically ceases if the beneficiary is no longer a vulnerable person?

We believe that the test should only be whether the beneficiary is a vulnerable beneficiary when the trust is set up, so that any subsequent change of status would have no effect. That way, the settlor of the trust can have certainty, as can the trustees and beneficiaries. This would also reduce the administrative burden of having to check each year whether the trust qualifies.

Q4: Do respondents agree that including recipients of the enhanced rate daily living component of PIP within the vulnerable beneficiary definition would achieve certainty in the same way the existing reference to DLA does?

The Society agrees that this definition does achieve certainty, but does not feel that this adequately covers all potential definitions of vulnerable beneficiaries. As noted in the answer to Question 1, many people would consider a much broader definition of 'vulnerable' to be appropriate.

Q5: Would including recipients of the enhanced daily living component of PIP within the vulnerable person definition be an effective category to support the targeting of the tax treatment for those beneficiaries with a severe physical or mental disability?

It perpetuates the present situation and may lessen the number of potentially vulnerable beneficiaries for whom or by whom a trust that meets the qualifying conditions may be set up.

Q6: What are respondents' views on whether the proposal for PIP might lead to a suitable test, or part of a test, for assessing whether someone should be able to benefit from access to the tax treatment for vulnerable persons' trusts?

The Society is concerned that linking the special tax treatment for vulnerable beneficiary trusts to a state benefit may cause problems and have unexpected consequences. Whilst the definition is certain, it can lead to difficulties, for example if the beneficiary shows some sign of improvement, so as to lose the enhanced daily living component of PIP, but it might still be appropriate to keep funds in trust for that beneficiary.

If the test as to whether the beneficiary is a vulnerable person is only done once, when the trust is first set up, then that would be simple to administer and easy to understand. To the extent that this may not fit with HMRC policy, then one proposal might be to ensure there are transitional provisions to assist those trustees who find their beneficiary no longer qualifies as a vulnerable person. This might, for example, give a set period of time to see whether the beneficiary re-qualifies (perhaps after appealing the reduction in benefits) or allow the restructuring of the trust without adverse tax consequences.

Q7: Is the existing 'mental incapacity' test suitably targeted? If not, why not?

We have no comments.

Q8: What alternative approach would respondents propose and why?

We have no comments.

Q9: What practical issues do respondents experience when applying the current ‘mental incapacity’ test, or envisage with any alternative; and how could they be overcome?

For the reasons set out above, the Society considers that a beneficiary can be a vulnerable person, even if they do not suffer mental incapacity. There may be many reasons why someone is unable to manage their financial affairs, without actually lacking mental capacity.

This focus on the definition of mental incapacity overlooks the fact that there may be a large number of other potentially vulnerable beneficiaries. We believe, as previously stated, that the settlor of a trust should be given the option of setting up a vulnerable beneficiary trust, with the restrictions that will entail (see below).

Q10: Do respondents see any reason why the ‘application of capital’ conditions should not require the vulnerable beneficiary to benefit from every application of capital during the lifetime (or other relevant period) of the vulnerable beneficiary (with consequent changes to the provisions disregarding trustees’ general statutory powers of advancement)?

We believe as individual beneficiary’s circumstances differ, there would be advantages in retaining the current or at least a limited possibility of applying capital to other beneficiaries, so long as at least the majority application is for the vulnerable beneficiary.

We feel that there must be an ability to pay income (and capital) to others than the vulnerable beneficiary, but there should be a requirement that all or most of the capital and income is paid for the benefit of the vulnerable beneficiary.

Q11: Do respondents see any reason why the ‘application of income’ conditions should not be harmonised so that trustees are prevented from paying income to non-vulnerable beneficiaries during the lifetime (or relevant period) of the vulnerable beneficiary?

As noted above, our view is that there should be a power for trustees to apply income or capital, to a limited extent, to beneficiaries other than the vulnerable beneficiary. We can also foresee occasions when trustees of a vulnerable beneficiary trust may wish to accumulate the trust income, rather than pay it out to the vulnerable beneficiary.

This limit on the use of income and capital could be the ‘restrictions’ referred to earlier, as the ‘price’ for setting up a vulnerable beneficiary trust. The advantages of setting up a vulnerable beneficiary trust could be that gifts to the trust would be potentially exempt transfers for IHT and possibly a full CGT exemption for the trustees.

To summarise, the proposal is that taxpayers can elect whether to set up a trust within the vulnerable beneficiary regime. If they do so, any gift to that trust is a potentially exempt transfer, and the trust assets are aggregated with the beneficiary’s personal assets for IHT. As with a pre-FA 2006 trust, there would be an uplift in the value of the trust assets for CGT on the death of the beneficiary.

The trustees of a vulnerable beneficiary trust would have power to accumulate, but would also have to ensure that the majority of any income or capital advanced is paid or used for the benefit of the vulnerable beneficiary (during their lifetime). Consideration could be given as to whether the trustees of a vulnerable beneficiary trust would have a full CGT allowance.

A trust set up for minor orphans or for those in receipt of the enhanced daily living component of the PIP could be deemed to be within the vulnerable beneficiary trust regime, unless the settlor elects otherwise.

Q12: Are any transitional provisions required? If so, what transitional arrangements would respondents suggest?

This depends on whether the new rules, if introduced, will apply only to trusts set up after the rules are changed or to all existing vulnerable beneficiary trusts. We believe that it would be unfair to those existing trusts to find that they no longer qualify as vulnerable beneficiary trusts, despite qualifying when they were first set up. We therefore consider that a form of 'grandfathering' for existing trusts should be included in the new legislation.

Q13: What adverse impacts on the equality groups do respondents expect? How do respondents suggest any such impacts be mitigated?

We suggest that groups working with disabled people and those suffering from mental capacity issues be consulted.

Q14: Do respondents know, or can they estimate, the likely number or proportion of vulnerable beneficiary trusts for severely disabled beneficiaries that currently qualify on the basis of the DLA criteria as opposed to the other two criteria listed at paragraph 2.9.

We are not able to give any figures, given that trusts are not registered.