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Who should pay a wealth tax? Some design issues

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Abstract

Any wealth tax design needs to resolve the question of who should pay it it How wide should the net be cast? Setting high or low exempt thresholds affects avoidance behaviour and may influence whether one should tax by reference to the household (and if so how that should be defined) or simply on each individual who owns wealth over a certain threshold. Typically, wealth taxes in other countries have not been imposed on non-residents except in relation to real property but questions remain over whether any exempt period should be given to new arrivals, not least for administrative convenience. A one-off wealth tax would require a different design in a number of respects from an annual wealth tax. For example, a one off tax t would need to be designed to catch those who have recently left the UK and contain modifications for recent arrivals. Trusts, foundations and similar vehicles pose particular problems in the design of a wealth tax and the author suggests some possible solutions and connecting factors that could be considered.

KEYWORDS
avoidance, one-off tax, tax design, wealth tax, household, trusts

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D31, H24

1 | INTRODUCTION

This paper is concerned primarily with the question of who should pay a wealth tax and in what circumstances, if such a tax is to be levied. For a much fuller consideration of design issues, including what assets should be included in the taxable base, how debt should be covered and comparisons with other countries, see Chamberlain (2020).

Three key questions to consider are the following.

- Should the taxable unit be the individual or the household? If the latter, how do you define household? There are pros and cons to each option, as discussed in Section 2.

- What connecting factors should be used to connect people and assets to a country, and therefore to determine the tax base (see Section 4)?
- Should the taxable unit include standard vehicles that are used to hold personal wealth – typically trusts, foundations and private investment companies? There are a variety of options: a trust could either be taxed as a separate person in its own right or simply be regarded as another type of asset includible in the taxable base of a particular individual or household? This issue is far from straightforward but is discussed briefly in Section 5. For a fuller discussion, see Chamberlain (2020) and appendices.

The answer to the question of *who pays* is clearly affected by the thresholds and rates used. A high exempt threshold may solve a number of administrative problems including enforcement, valuation and liquidity. However, high thresholds encourage fragmentation of ownership. Section 3 draws the various elements together.

2 | PERSONS LIABLE – WHO PAYS?

2.1 | The individual or the household?

The 1974 UK Green Paper on wealth tax suggested that the natural unit of taxation for the purposes of wealth tax, at least from the social point of view, should be the family. This was justified on the basis that 'the family is the basic social unit in private life; and the long-standing rule for the aggregation of the incomes of husband and wife for income tax purposes [...] still has wide application and normally reflects the realities of the matrimonial situation'.[1] The argument was that the family as a whole is benefiting from the wealth in terms of better housing, access to better educational opportunities, etc. The Irish Wealth Tax (1975–78)[2] aggregated not only the wealth of the spouse and minor children with that of the husband but also that of a discretionary trust where the sole beneficiaries were spouse and/or children.

In the report by OECD (2018), it was similarly noted in the context of wealth tax that '[...] there are strong arguments for using the family as the tax unit. If spouses were to be taxed separately it would be difficult to determine and split the ownership of household assets and to allocate the wealth of dependents to either one of the parents. In addition, in the case of a wealth tax with progressive rates and exemptions and deductions, taxing spouses separately would require closely monitoring transfers of assets between spouses.'

The Meade Report[3] came up with conflicting criteria in debating whether to tax the household or the individual. On the one hand, Meade acknowledged that the decision to marry should not be affected by tax considerations and, on the other, claimed that two persons living together and sharing household expenditures can live more cheaply and therefore have a greater taxable capacity than two single persons living separately. Countries vary in approach. For example, France, Norway and Switzerland tax on the basis of the household rather than the individual although their exact approaches differ. By contrast, Spain levies wealth tax on an individual basis and not on the family as a whole.

Even if it is decided to tax the household rather than the individual, it is still necessary to define the household. Should it include just spouses and civil partners or also include cohabitees, minor children and even adult children?

2.2 | Points in favour of taxing by household

(a) *Other capital taxes*. The UK tax system is not consistent in its current approach but capital taxes do operate to some extent on a joint basis. While the income of husband and wife is no longer

[1] See HMSO (1974, Chapter2, Section 8).

[2] Sandford and Morrissey, 1985.

[3] Meade, 1978.

aggregated for income tax purposes and they each have their own personal allowances and pay at progressive rates, there is still legislation to stop them splitting income where there is not an outright gift of property.[4] Wealth is freely transferable between spouses/civil partners in the capital gains tax (CGT) and inheritance tax (IHT) contexts, and some IHT allowances, such as the nil rate band, can be transferred on death. This would suggest that wealth tax could be calculated by reference to the wealth of the family as a whole rather than the individual.

(b) *Fairness*. The family as a whole may well benefit from the wealth (in terms of better housing, etc.). Aggregating all the wealth of unmarried minor children with that of their parents is fair because a wealthy child relieves the parents of certain financial obligations.

(c) *Administrative ease*. Taxing on a household, rather than individual, basis could bring administrative ease by requiring only one return. The tax could be *computed* by reference to the joint household wealth but if it is *paid* separately with individual liability and separate assessments, this would ultimately necessitate at least two returns.

(d) *Reduces dispute over property rights*. Aggregation would avoid dispute and uncertainty over who owns what.[5] Instead of having to work out which spouse owns what property or whether joint property is owned 50/50 or 80/20, the individual position will be irrelevant to the computation of the total wealth tax liability (although it may be relevant in determining how the tax will be borne within a household).

(e) *Welfare approach*. The household approach is adopted generally in the welfare system and for student loan entitlement, which is affected by the cohabitation status of the parents. Why should tax be different?

(f) *Other design aspects are easier*. It makes the operation of an alternative minimum tax of the sort suggested by Summers (2021) easier. All households within scope of the tax would be required to pay a minimum total amount in tax calculated as a percentage of their total household wealth. If the household already paid more than this amount in other taxes, then there would be no additional tax to pay. It allows exempt thresholds to be set at a higher level as fragmentation between spouses is less likely. See (g) below.

(g) *Avoidance*. Taxing by household can stop avoidance as it discourages purely tax incentivised transfers between spouses. Aggregation of household wealth is more necessary where there is a high exempt threshold and progressive rates (albeit this system is generally seen as fairer). To take a simple example, if the exempt threshold is (say) £300,000 per individual with a 0.1 per cent rate, the tax loss is relatively slight if one spouse chooses to divide their £1 million wealth so that each spouse owns £500,000 and tax is imposed on an individual basis. But if the wealth tax starts at £1 million per individual with steeply progressive rates, fragmentation becomes much more relevant. Transferring wealth to a less wealthy spouse is not necessarily undesirable but it could lead to significant loss of revenue unless the household unit is used. Further, if one spouse is non-resident and one is resident in the UK, wealth tax can still be charged on the family wealth under a household system but this is much harder under the individual system of taxation and can lead to people avoiding tax simply by transferring assets to non-resident spouses (albeit still enjoying the benefits they produce).

2.3 | Points against taxing the household rather than the individual

Arguments for taxing on an individual basis are as follows.

(a) *Tax should follow the ownership of property*. France and Switzerland both have what are called community of property regimes: broadly, a couple are deemed to own property acquired after

[4] See certain anti-avoidance rules called ‘the settlement rules’ in ITTOIA 2005 Part 5 Chapter 5.

[5] See *Moutreuil v Andreewitch*, 2020 EWHC 2068 Fam for difficulties in agreeing who owns what.

marriage jointly. Hence it makes more sense to tax them as a single unit for wealth tax purposes as that aligns with their property rights. However, the UK does not generally have such a regime. There is no presumption that a married couple own wealth jointly. There may be situations where the courts intervene to provide for the other spouse on certain life events such as divorce[6] or death[7] but that is simply an acknowledgement that a transfer of property is required to ensure fairness after a life event; in any event, this is at the discretion of the court and depends on a range of factors. It does not affect the ownership of property during the course of marriage, which can be highly relevant where the wealthy spouse becomes bankrupt. In 'Independent taxation: lion or mouse?', Freedman (1988) pointed out the difficulty in divorcing tax law from property law: '[…] it is difficult to devise and operate a sensible and coherent system of independent taxation when underlying property law does not make clear what are the respective interests of the spouses in any given property.' The argument is essentially, why should one spouse be subject to higher rates of tax on their wealth because of their partner's wealth to which they may never have access or enjoyment? It does not invariably follow (as the 1974 Green Paper suggests) that the taxable capacity of the family is simply the combined wealth of both partners.

(b) *Discrimination between marriage and cohabitation*. Taxing only married couples/civil partners but not cohabitees as one unit may be seen as unacceptable given the increase in cohabiting couples in the UK and the number of quite complicated arrangements. However, bringing in cohabitees as part of the tax base of the household raises definitional problems and may encourage intrusive questions from a revenue authority. OECD (2018) acknowledged this when it noted that joint taxation would usually only be an option for spouses/civil partners not cohabitees even if the difference might be difficult to justify from the perspective of horizontal equity.

(c) *Including all children in one taxable unit can be difficult and unfair*. It is one thing to tax spouses as a single unit, but should children also be included as part of a single household? How far should the household extend? On the one hand, if children are taxed as separate units, it is relatively easy to give assets away to them and thereby reduce the wealth of the household as a whole below an exempt threshold. On the other hand, it is surely disproportionate to combine the wealth of *adult* children with that of their parents, particularly if they are estranged or earned it entirely independently. Minor children might be seen as a different case and there seems no reason why their wealth should not be aggregated with that of the donor parent (see below).

(d) *Who pays?* If the wealth of couples (whether married or cohabiting) is aggregated, who pays, and how is the liability split? If taxed as one unit, the liability for the tax could be prorated between members of the family and taken from their respective pots of wealth, but this still leaves open the question of who is actually responsible for filing the return and paying the tax. Taxation by household, from the HMRC perspective, would likely favour HMRC being able to take all the tax from either party, otherwise HMRC are into the business of working out who owns how much of what. However, this may prove unacceptable for taxpayers. Why should one spouse be liable for the other's wealth tax liability, particularly if they have no practical access or even knowledge about the wealth? What happens where individual A has high value assets (e.g. a family company) but no liquidity and individual B has lots of savings or income that are effectively then used to pay the wealth tax of the other? It may not fairly reflect how property ownership is in reality divided, particularly if, on divorce, B is allocated no stake in the company of A on which B has paid wealth tax. Even if the tax is computed by reference to the household wealth but liability is prorated, B has paid more wealth tax due to assets owned by A (the family company) from which B may derive no personal benefit. So, in practice, household taxation may not be as administratively easy or as fair as initially thought.

(e) *Privacy*. Taxing by reference to household or individual is not purely a question of tax avoidance or taxable capacity; it also raises wider issues about independence, privacy and interdependence

[6] Matrimonial Causes Act 1973.

[7] Inheritance (Provision for Family and Dependants) Act 1975.

of the spouses/cohabitees. The design of the current welfare system has been strongly criticised because forming family units can lead to a loss of benefits and greater financial insecurity.[8]

(f) *Complexity*. Even if aggregation of wealth by household is feasible in stable long-term situations, it will be harder in more mobile families or where relationships are complicated; for example, someone might split up from their spouse in order to live with another person for six months before finding themselves single again. Is aggregation to be determined by someone's status at a particular point in the year, for example, 5 April, which is the end of the UK tax year, irrespective of their marital position for the majority of the previous or next year? These are not insurmountable points, but they would certainly make administration more complicated, particularly given a wealth tax return will typically be filed by reference to hsitoric ownership of wealth.

Some countries resolve these contradictions by taxing the household but doubling the threshold. However, this approach is not neutral. If the threshold is not doubled, couples face a wealth tax disincentive to get married. If the wealth tax exemption is doubled and tax is by reference to households, there is an advantage to marriage when one partner is well below the wealth threshold as the richer party is better off, having now doubled the threshold at which their wealth starts to be taxed.

2.4 | One-off wealth tax

Overall this author does not favour household taxation except in a limited way in relation to a one-off wealth tax. A one-off wealth tax could be assessed on an individual basis, although couples could choose to be taxed together to prevent unfairness if assets happened to be held very unequally at the valuation date. Individuals could elect to transfer any unused allowance to their partner, in a similar manner to the transfer of the nil rate band under IHT. Alternatively, couples could be allowed to elect into joint assessment so that their assets and allowances were aggregated and then liability prorated between them.

2.5 | A hybrid solution?

In relation to both annual and one-off taxes, the author suggests the overall approach could be an individual system of taxation but the wealth of the spouse/cohabitee/minor child could be aggregated to that of the donor to the extent they had acquired it by gift from the other spouse/cohabitee/parent. If they are all independently wealthy, then no aggregation occurs.

This raises problems of policing transfers between spouses, which may not always be easy to resolve. Of course, the system could be extended to all gifts to family members – for example, where a parent gives assets to an adult child, those assets could be included in the taxable wealth of the parent. However, this would raise some extraordinary compliance issues if it operated without a time limit. It is also difficult to see why a gift to an independent adult should not simply be included in their own taxable wealth, provided the parent has no continuing control and derives no benefit from it. Where the gift was 'artificial' and the parent derived some continuing benefit from it (e.g. the parent gives away a house but still occupies it rent-free), then the gifted property could be clawed back into the donor's estate for wealth tax purposes.

For valuation purposes, 'related party' rules should apply such that in the case of spouses and civil partners their property is valued as one combined unit, with each spouse owning a proportion of the combined unit. Similar provisions already apply for IHT.

[8] Griffiths, 2017.

3 | TAX EXEMPTION THRESHOLDS, RATES AND CAPS

The rates and exempt threshold of any wealth tax have significant effects on certain design features. This section briefly summarises the issues.

3.1 | Rates and thresholds

Wealth tax exemption thresholds and rates have varied significantly across countries. In France and Spain, there is a high exemption threshold with high rates; in Switzerland and Norway, the exemption threshold is low with lower, flatter rates.

In 1974, the UK Green Paper proposed a hypothetical exemption threshold of £100,000 (equivalent to about £1 million today) and a starting rate of 1 per cent, increasing to 2 per cent over £300,000, 3 per cent over £500,000 to £2 million, 4 per cent from £2 million to £5 million, and 5 per cent over £5 million (£500,000 being equal to about £5 million today).

A single flat rate applying across a broad band of taxpayers and starting at a relatively low threshold reduces the incentive to fragment or divide wealth between different entities or persons such as spouses/children/trusts and therefore reduces the need for complicated (and sometimes ineffective) tax avoidance legislation. Fragmentation becomes an issue if the threshold is high or the rates are progressive.

While low exempt thresholds and flat rates have attractions in terms of deterring fragmentation, a high tax exemption threshold combined with higher rates is often justified on the grounds of equity: only the very wealthy pay the tax and the potentially distortive effect of wealth taxes on modest savings is reduced. A high tax exemption threshold also has the significant benefit of limiting administrative and compliance costs. In particular, HMRC would have the resources to check valuations properly, simply because it would be doing fewer of them; high volumes of taxpayers would not overwhelm HMRC with the need to value all their assets.[9] Problems of liquidity may also be seen as less pressing in relation to a high exemption. For example, as Loutzenhiser and Mann (2021) note, the problem of the single retired person living in the big house with little income is removed if the threshold is £2 million but is significant at £500,000. However, they also show that while the *volume* of liquidity cases may be reduced, a high exempt threshold does not remove liquidity problems in relation to more valuable farms andbusinesses.

A high tax exemption means that most taxpayers will never need to value their assets at all as they will obviously be below that limit. This will reduce compliance costs. In 2018, the OECD suggested that a net wealth tax could still raise significant revenues even if the exemption threshold is set at a high level, provided that the tax base is broad with few exemptions. This is the model that has been suggested recently in the US.[10] The argument is presumably that a high threshold may reduce the need for reliefs and discounts in relation to particular assets. However, this is not borne out by international experience: France, Norway, Spain and Switzerland all have very different rates and thresholds but all give similar discounts to the main residence and, in fact, Norway and Switzerland (low rate/low threshold) give less preferential treatment to businesses and have fewer reliefs. Higher exempt thresholds do not seem to produce a broader tax base – possibly because wealthy elites may find it easier to press quietly for an exemption.[11]

[9] See Daly, Hughson and Loutzenhiser (2021).

[10] Batchelder and Kamin, 2019; Saez and Zucman, 2019.

[11] See Perret (2021).

3.2 | Caps on wealth tax by reference to income

Ceiling provisions or tax caps are common features of net wealth taxes – usually introduced to deal with liquidity issues.[12] The caps operating in Europe are by reference to income rather than total wealth. They sometimes consist in setting a limit to the combined total of net wealth tax and personal income tax liability as a maximum share of income. In France, the wealth tax ceiling limits total French and foreign taxes to 75 per cent of taxpayers' total income. In Spain, the aggregate burden of income tax and net wealth tax due from a Spanish resident cannot exceed 60 per cent of their total taxable income, although there is also a floor provision requiring a minimum of 20 per cent of the net wealth tax as originally calculated to be paid. Seven out of 26 Swiss cantons have some form of cap based on wealth tax payments as a share of total taxable income. Norway does not have a tax cap.

Linking wealth tax to taxable income in this way can create significant opportunities for tax avoidance as revenues can be manipulated and there are incentives to reduce income.[13] For taxpayers whose tax liability is at or above the tax cap, owning more wealth does not result in more tax. But an increase in income will raise the tax cap and thus increase the wealth tax liability. If a wealth tax is intended to tax capital because the benefits of owning that capital are not adequately reflected by taxing the income it produces, it seems odd to cap it by reference to the amount of total income. One might as well stick to taxing income – possibly with a surcharge on investment income – and avoid a wealth tax altogether. This was indeed the option chosen by Labour in 1974.

An alternative floated by Summers (2021) is to use a wealth tax as an alternative minimum tax (AMT), effectively serving as a backstop for income tax and CGT. All individuals within scope of the tax would be required to pay a minimum total amount in tax calculated as a percentage of their wealth. If the individual already paid more than this amount in other taxes,[14] then there would be no additional tax to pay. In effect, this is equivalent to giving relief against wealth tax for those who already pay a lot of other taxes (e.g. because they have a high income). It does not of course deal with liquidity concerns – rather the opposite. Unlike the French model, the wealth tax is paid by those who actually have less taxable income and it still requires the estate to be valued and disclosed in order to ascertain whether the AMT is applicable at all.

3.3 | Caps related to total wealth

No European wealth tax system as part of its *wealth tax design* offers a cap based on the total amount of capital. However, such an approach could be adopted in the UK – there is already some precedent as the annual tax on enveloped dwellings (that broadly applies to houses owned by companies occupied by shareholders) applies a maximum tax cap to houses worth more than £20 million (£237,400 tax).

3.3.1 | Advantages of a wealth cap

(a) It can assist liquidity for those with very high wealth, particularly where the wealth is tied up in a single asset such as a company, which appears to be more likely at higher levels.[15]
(b) It reduces the need for valuation by the very wealthy – they just pay the fee without worrying about what their assets are worth. It does not necessarily assist those with wealth at lower levels and can seem unfair if you fall into the lower end of a wide band.

[12] For a fuller discussion, see Loutzenhiser and Mann (2021).

[13] See comments on Spain's behavioural response in Section 3.4 of Advani and Tarrant (2021).

[14] Presumably only UK taxes not foreign taxes would be taken into account.

[15] See Loutzenhiser and Mann (2021).

(c) It can assist compliance and protect privacy at the top level – the very wealthy and HMRC do not need to get into lengthy discussions each year as the taxpayer is paying the maximum amount anyway.
(d) It can reduce avoidance as there will be a positive disincentive to split wealth among trusts and other vehicles if the very wealthy individual can pay a maximum lump sum.

3.3.2 | Disadvantages

(a) The setting of the maximum cap and the bands is likely to be controversial and subject to political football.
(b) Bands may be perceived as unfair by those of lesser wealth at the lower end of each band.
(c) Bands do not necessarily deal with valuation or liquidity problems for the moderately wealthy.
(d) The maximum cap favours the very wealthy and may cause resentment both from those below the cap and those above it. It breaches horizontal and vertical equity. Should someone with £50 million of wealth pay the same as someone with £1 billion? If the wealth tax starts at a low level, the middle class may well feel that they are paying proportionately much more than the extremely wealthy who can use the tax cap. That may suggest a high exemption threshold is necessary.
(e) It may result in different avoidance behaviour by encouraging aggregation of wealth at the top level so one person pays a single maximum amount, which could be less than the total of two people paying lower amounts separately.

4 | TERRITORIALITY: CONNECTING FACTORS

A common objection to wealth tax is that it will lead to emigration of the wealthy.[16] Furthermore, it is said that if a country has a wealth tax, this may deter people from moving there in the first place. This section examines briefly the evidence for these objections and then considers in more detail whether any design solutions could be adopted.

4.1 | The effect of wealth taxes on emigration and immigration

Advani and Tarrant (2021, Section 3.7) suggest that the migration response in terms of leaving the UK altogether or coming here in the first place may be relatively small.[17] However, they suggest that differential wealth taxes between different regions within the same country can (at least in relation to Switzerland and Spain, where the internal rates and exemptions vary quite considerably) lead to significant migration between regions. Duff (2005) is persuasive that a failure to integrate federal and provincial taxes properly can lead to higher administrative and compliance costs, and can undermine the tax base altogether, leading to eventual abolition. In his view, looking at Canada, Australia and New Zealand, it is preferable to operate a federal/national system of capital taxes to stop migration between regions and a race to the bottom. Unless the government were to decide to allow different wealth tax rates to be set by the devolved administrations, the issue of subnational wealth taxes does not need to detain us here.[18]

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[16] See Perret (2021).

[17] See also Brülhart et al. (2017).

[18] For the geographical impact of a wealth tax, see the website of the Wealth Tax Commission (https://www.ukwealth.tax/) – much will depend on the type of asset included in the wealth tax base.

4.2 | What connecting factors?

Every country has to work out the territorial limits of its tax base. A government cannot impose wealth tax on everyone in the world. How does it determine liability? The key connecting factors adopted are generally 'residence' and where the assets are situated (i.e. 'situs').

All countries with a wealth tax impose wealth tax on real estate held directly by the non-resident person or through companies owned directly or indirectly by such non-resident person; some countries, such as Spain and Germany, also impose wealth tax on bank accounts and other investments situated there and owned by non-residents.

Generally, all such countries tax residents of their country on worldwide wealth but some, such as Spain and France, provide periods of exemption for immigrants. Norway and Switzerland do not. Generally, no wealth tax liability arises on non-residents for assets situated outside the country (except in relation to foreign companies owning real estate) but some countries, such as Germany, India and Spain, have had a tail so that wealth tax on a worldwide basis was imposed annually on the non-resident for a minimum period after departure. France, Switzerland and Norway avoid this.

Broadly consistent with the above, the 1974 UK Green Paper proposed that someone who was both resident in the UK and domiciled here would be liable to wealth tax on their worldwide assets.[19] Non-residents would not be within the charge to wealth tax except possibly on the value of UK land or assets held in connection with a permanent establishment in the UK. UK portfolio investments were specifically *not* to be subject to tax on non-residents, wherever domiciled. Those domiciled abroad but resident here would not be taxed on worldwide assets.

The current IHT regime may superficially seem the most relevant regime with which to align a wealth tax; after all, IHT is a tax on transfers of wealth, and wealth tax taxes the ownership of wealth. However, IHT is a once in a lifetime tax and broadly aims to tax someone who has spent a significant proportion of their life in the UK. The same point does not necessarily apply for annual taxes such as wealth tax. For example, it would be odd to impose an annual wealth tax on someone for many years after they had left the UK simply because they had retained UK citizenship or domicile.

The author suggests that domicile should be disregarded as a relevant connecting factor; it is uncertain in application and impractical to adopt in the context of a wealth tax. UK residence and situs of assets should be the only connecting factors.

4.2.1 | On what assets?

All UK real estate directly and indirectly owned should be chargeable to wealth tax wherever the owner is resident. In the author's view, it is not sensible to make non-residents pay wealth tax on mobile UK assets, such as bank accounts or quoted shares. Apart from discouraging UK investment by non-residents, the tax can easily be avoided simply by moving the UK asset into a foreign company owned by the non-resident individual. This is much harder in relation to land as UK real estate owned by a foreign company is subject to other rather penal taxes (including 15 per cent stamp duty land tax on transfer of the property into the company even if no consideration is paid). In any event, the required disclosure of UK land owned by non-UK resident entities makes enforcement of taxes on indirectly owned entities rather easier. It is appreciated that this could lead to some unfairness in terms of competition between UK and foreign shareholders, particularly in relation to UK private companies.

[19] Domicile is a complicated concept that can be related to whether a country is a person's permanent home and/or whether they had a domicile of origin in the UK at the date of birth. It is not the same as citizenship or long-term residence – for a proper discussion, see Appendix B of Chamberlain (2020).

4.2.2 | Residence

One question is whether all UK residents should be subject to the same level of wealth tax irrespective of how long they have been in the UK or whether there should be some minimum time during which they are exempt. France and Spain offer reliefs for the first five or three years, respectively, after a taxpayer arrives there. There are certainly good arguments for exempting (as the UK does) the non-UK assets of newly arrived residents from IHT. A new resident coming to the UK for a temporary work placement for three years might feel aggrieved to find themselves subject to the risk of 40 per cent IHT on their worldwide estate if they were unlucky enough to die here within those three years, particularly if all the wealth had been acquired prior to UK residence.

However, the arguments for exempting newly arrived residents from an annual wealth tax are less convincing. Given the wealth tax would be an annual charge payable only while resident in the UK, unlike IHT levied at 40 per cent, it would not unduly deplete worldwide wealth. The only real objection in the context of an annual wealth tax is that administratively it would be onerous to require a person intending to be resident here for only a limited period to have to disclose their worldwide wealth. The requirement to provide detailed valuations and disclosure of their worldwide estates (not an inexpensive exercise, particularly if it involves trusts) may be a significant disincentive to become a UK resident in the first place. This is presumably why some countries operate exemptions for a minimum period. An alternative to exemption is to let newly arrived residents pay a maximum capped amount for a minimum period in exchange for non-disclosure of foreign wealth.

A separate question is whether emigrants should escape all wealth tax from the start of the first tax year throughout which they are non-UK tax resident[20] or whether a tail should be imposed for a minimum period after departure.[21] The arguments for imposing a tail are weak, and administratively it becomes complex. It is unnecessary if the annual wealth tax has operated properly during the period of residence as wealth has already been taxed annually. Liability does not depend on a transaction (cf. CGT where realisation of the gain can be deferred to a later date after emigration and therefore is more prone to manipulation).

The arguments for a one-off wealth tax are rather different, particularly if it has been anticipated for some time. In the final report of the Wealth Commission, Advani et al. (2020) recommended that under a one-off wealth tax there should be a 'backwards tail' based on residence in the years preceding the assessment date. For example, if an individual had been resident in the UK for at least four out of the previous seven tax years preceding the year of assessment, a one-off worldwide wealth tax could still be imposed even if they were not resident in the UK in the tax year when the assessment date fell. For new arrivals who were resident in the year of assessment but had only been resident for fewer than three years previously, a prorated charge could be adopted, tailing to nil for those who first arrived in the year of assessment.

4.2.3 | Other issues

The only other issues are whether the non-resident should be subject to a higher rate of tax or have a lower exempt threshold than a UK resident on their UK real estate. Non-residents now pay 2 per cent more stamp duty land tax than UK residents but the policy justifications for this are perhaps unprincipled. Whatever approach is adopted for rates, it would certainly be necessary to restrict relief for debt, otherwise the non-resident will simply load the UK real estate with debt so the net taxable value is reduced to nil.

[20] As in France, Norway and Switzerland.

[21] As in India, Germany and Spain.

5 | TRUSTS/FOUNDATIONS/USUFRUCTS AND ESTATES

This section sets out some considerations when taxing trusts. It is, however, a very basic analysis for the lay reader. For a more comprehensive review, see Chamberlain (2020).

5.1 | Introduction: what is a trust?

Non-lawyers tend to see ownership of an asset in binary form: you either own or do not own the relevant property. However, trusts allow a more subtle type of ownership whereby the person who controls the asset and has legal title (the trustee) is different from the person who may in the future benefit from it or does now receive some benefits (the beneficiary). This 'split' type of ownership is seen in other types of vehicles, such as foundations and usufructs found in Europe and not discussed here.

The Recognition of Trusts Act 1987 defines the position thus.

> 'For the purposes of this Convention, the term "trust" refers to the legal relationship created—inter vivos or on death—by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.
>
> A trust has the following characteristics—
>
> (a) the assets constitute a separate fund and are not a part of the trustee's own estate;
> (b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
> (c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.
>
> The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.'

A common thread above is the obligations imposed on the trustee to act in good faith in the operation of the trust (obligations that give rise to a broad range of fiduciary duties) for the benefit of the beneficiaries and to recognise the rights of the beneficiaries.

Some beneficiaries may have an interest only in income, and some in capital. For example, a trust that paid 'all trust income to Fred for life and then to his children as the trustees decide' would be called a life interest trust for Fred who would have 'an interest in possession' and his children would have discretionary interests in the capital. In many cases, Fred's life interest might be revocable by the trustees and the trustees may have power to give Fred some capital.

Some trusts (called 'discretionary trusts') may give no definite interest in trust property to anyone and individuals simply benefit, if at all, from both income and capital entirely at the trustee's discretion. However, the beneficiary's right to enforce those obligations and to hold the trustee accountable, together with the separation of the trust property from the trustee's personal property, are very important characteristics of a trust. The trustee cannot do what he wants with the assets; the assets cannot pass to his creditors if he goes bankrupt and he cannot deal with them except as set out in the trust deed.

The general principle often stated is that no tax advantage or disadvantage should follow from holding assets in trust rather than giving them to an individual. Trusts, say HMRC in their 2018 consultation,[22] should be neutral for tax purposes. However, this is easier to state than achieve. Neutral in comparison to what? Comparing a gift to a trust with an outright gift to an individual with retaining outright ownership is difficult. The individual who receives the gift or retains outright ownership has full ownership and control. A gift to a trust confers control on the trustees – the people who hold the property – but does not give them the right to benefit from the property.

As can be seen above, there are three players in a trust scenario – the settlor (the person who 'settles' or gives the assets into trust), the beneficiaries and the trustees – and the various powers, benefits and controls they may each retain or receive will vary considerably from trust to trust. They may each be resident in different jurisdictions, each with their own rules. A settlor may be a trustee and a beneficiary or take no further interest in the trust. It is the very variety of trusts that makes them so difficult to categorise and therefore to tax.

A further key characteristic of a trust is that it has no legal personality of its own. This can be contrasted with a company, which is a separate legal entity that can be sued and holds property in its own right.

Trusts are therefore fundamentally different from outright gifts. For example, if I give away shares to my children, they own and control an asset that can be valued. The shares may produce little income or have restricted rights on sale or liquidation but all these points can be taken into consideration when valuing what the children own. Even if I give away my house to my children and continue to live in it at their discretion, the house still belongs to the child and can be taxed on them if they are resident in the UK.

By contrast, if I give shares away to a discretionary trust and either exclude myself from benefit or die, it is not clear who should be taxed and on what basis. If I cannot benefit or control the trustees, why should I be taxed, apart from the fact that I chose to make the gift in the first place? I may have given the shares away many years ago and have little involvement now. It is very likely that the original terms set out in the trust deed may have been changed by the trustees to take account of different beneficiaries and different circumstances. The trustees may or may not act in accordance with the settlor's wishes.

OECD (2018, Chapter 4, p. 90) takes a very simplistic approach, ignoring the practical problems and legal reality of trusts and noting simply: '[t]reating trusts as see through entities seems appropriate. Following the approaches adopted in France and Spain, trusts can be treated as transparent or "see through" in the sense that the trustee is legally obligated to identify the settlor or beneficiary to tax authorities with the value of assets held in the trusts and then allocate these assets to the settlor or to the beneficiaries on a proportional basis to their assessable wealth.'

The author disagrees. If I as settlor am resident in the UK but am irrevocably excluded and no UK-resident beneficiary receives any income, capital or other benefit from the trust fund, why should I or they be taxed on it? That leaves the trustees as the third possible player, but then on what basis should they pay wealth tax: by reference to the residence of the settlor, beneficiaries or trustees or the situs of the trust fund, or all three? The results of the Spanish and French approaches have not been successful in practice at stopping avoidance.

In short, trusts should not be a vehicle for tax avoidance but there are often very good non-tax reasons to set up trusts: succession, protection of the vulnerable, etc.[23] They are an enormously important part of wealth holdings and a more analytical approach must be adopted if any wealth tax is to work properly and fairly.

There is no perfect solution and some leakage of tax as well as unfairness is perhaps inevitable.

Below may be a possible solution, which strikes a reasonable balance between arbitrariness and avoidance, acknowledging that the settlor or beneficiary does not own the asset outright but nevertheless accepting that benefits conferred by trusts need to be taxed and that the settlor has a

[22] See https://www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review.

[23] See Appendix A of Chamberlain (2020).

choice about whether to make an outright gift to someone or to settle it in trust. It should be noted that a slightly different design would need to be adopted for a one-off wealth tax in relation to trusts, which is discussed further in Advani et al. (2020). In particular, it is likely that the residence of the beneficiaries and settlor in the relevant year when the one-off wealth was imposed would be relevant to the trust's liability, irrespective of the settlor's residence when the trust was funded or whether a beneficiary received any benefits in that tax year.

5.2 | Summary of a possible design for an annual wealth tax for trusts

(a) Trustee residence should be irrelevant to wealth tax liability.[24] Trust residence is too easy to manipulate simply by appointing professional trustees outside the UK.
(b) Domicile of settlor and beneficiaries is also irrelevant in determining wealth tax liability.
(c) Where the trust holds any UK real estate, it is subject to wealth tax at the highest rate and the tax is paid out of the trust fund. This is irrespective of the residence of settlor or beneficiary.
(d) If the settlor was resident in the UK when he funded the trust or he or spouse/civil partner/minor child subsequently becomes a UK resident <u>and</u> in either case he or his spouse/civil partner or minor child can benefit from the trust or it is revocable, the trust fund is liable to wealth tax while he is alive (with the rate determined by and aggregated with his personally owned assets).[25]
(e) Where the settlor/spouse/civil partner/minor child is excluded but the settlor was resident in the UK when he funded the trust, the total trust fund is subject to wealth tax permanently (irrespective of whether the settlor dies or emigrates) at the highest wealth tax rate with the threshold exemption split between the trusts set up by the settlor (to discourage multiple trusts), irrespective of the residence of beneficiaries or type of trust.

    If such a trust makes capital distributions to discretionary beneficiaries who are resident in the UK, then such capital can be included in the beneficiary's wealth tax base and a repayment may be possible if the beneficiary has little further wealth. If the trustees make capital distributions to beneficiaries who are not resident in the UK, then those beneficiaries can reclaim wealth tax paid by the trustees in that year.

    While the option of permanent taxation of the trust dependent on the settlor's status at date of funding might seem harsh, the remedy is in the trustees' hands in that they can always 'complete' the gift of the settlor and advance the trust assets to the beneficiaries. If there are no beneficiaries resident in the UK or UK assets, annual wealth tax will then stop on termination of the trust. Thus, the trustees of a dead settlor who was resident in the UK when he set up the trust would still be liable to annual wealth tax even if there was no other connection to the UK.[26]
(f) Where the trust is discretionary but the settlor was not resident in the UK when funding it and cannot benefit, one could tax the trust fund by reference to the number of beneficiaries resident in the UK who could potentially benefit in any relevant year, on the basis that if the settlor had given those beneficiaries the assets directly then they would have paid wealth tax personally. The difficulty is that potential benefits under a discretionary trust are not as such rights – the beneficiary may eventually receive nothing. If they do receive something, then they will pay wealth tax at that point; therefore, the possible unfairness of taxing the trust now by reference to the status of a beneficiary who may receive nothing can be resolved later.

[24] This follows the approach adopted for IHT.

[25] This is not dissimilar to the approach adopted in recent anti-avoidance legislation on offshore trusts in relation to 'close family members'.

[26] The approach is similar in some respects to that adopted for IHT.

It may therefore be fairer to impose wealth tax only to the extent that benefits are actually conferred on beneficiaries who are resident in the UK (such as use of UK houses, any art or soft loans). However, valuing and then taxing such benefits may not be straightforward.[27]

(g) If the trust is what is termed fixed interest (for example, 'income is payable to Fred for life', and either the settlor was resident in the UK when he funded the trust or Fred, the 'life tenant', is resident in the UK at any time), then the whole trust fund is subject to annual wealth tax and the rates broadly determined by reference to the personal circumstances of the life tenant.

(h) If the life tenant is not resident in the UK and there are no UK trust assets and the settlor was not resident in the UK at the time of funding the trust, then the trust is only chargeable to wealth tax if another beneficiary who is resident in the UK actually takes some benefits during the year.[28]

(i) Liability in all cases would be funded out of the trust fund unless the trustees did not pay it, in which case after 12 months it could be imposed on the UK asset or on the beneficiary or settlor resident in the UK that has caused the tax liability to arise, and the latter would have a statutory right of recovery against the trustees.[29]

(j) The actual value of the beneficiaries' interests under the trust would be ignored. So, for example, a person with a life interest in the income of the trust fund, which can be revoked at any time, clearly has an interest of no real commercial value. Similarly, discretionary beneficiaries have nothing in the real world that they can charge or sell. The wealth tax charge does not relate to the value of those interests but the value of the property held in the trust, and must therefore ultimately be discharged from that property.[30]

Once liability has been determined, a secondary question concerns the rates. Should trusts be taxed at the highest possible rates with no threshold or as independent separate entities? The latter option invites avoidance by fragmentation. Possible options are discussed in more detail in Chamberlain (2020) and briefly referred to above.

The above discussion attempts to navigate between the connecting factors of the various parties but there are, no doubt, other options. It has a certain level of complexity but tries to reflect the reality of trust benefits and the decisions of the settlor. On the one hand, the settlor is not penalised personally for setting up a trust from which he is excluded but. on the other hand. the decision to make a gift into trust rather than outright is reflected in a greater complexity of taxation. It is a more subtle method than just taxing by reference *only* to the residence status of the settlor or of the beneficiaries. The question is important because if the price for introducing an annual wealth tax was the abolition of IHT, without an effective wealth tax the tax yield on trusts could be seriously eroded.

6 CONCLUSIONS

The focus of this paper has largely been on the design of an annual wealth tax, although the same issues would have to be addressed for a one-off tax. However, an annual wealth tax would introduce considerable complexity into the tax system, particularly if IHT was retained. While a high exempt threshold has distinct administrative and valuation advantages, it will increase the possibilities for avoidance considerably, as taxpayers can plan over the years to fragment wealth between members of

[27] Similar problems are found in relation to benefits provided by offshore trusts to beneficiaries who are resident in the UK, and the tax system currently deems them to be valued in a certain way.

[28] Otherwise it would be easy to channel benefits to UK resident beneficiaries but insert a peg life non-resident as the life tenant and minimise the income they receive.

[29] It might be objected that where the trustees were non-UK resident the beneficiary could not enforce this liability – however, the trustees must act in the best interests of beneficiaries. The problem would be harder for a settlor who has been excluded but was UK resident when the trust was set up.

[30] This again follows the approach adopted in IHT and CGT

the family and trusts, so as to fall under the exempt threshold. Targeted anti-avoidance legislation can be introduced to stop this. However, such legislation often has other adverse or unexpected effects, even assuming it can be made to work well. A one-off wealth tax does not face similar constraints, provided the valuation date is set before the date of announcement and this date is also the relevant date for determining liability to wealth tax. As discussed in the final report of the Wealth Commission,[31] various forestalling measures can be built into the design, which are not possible in the same way for an annual wealth tax.

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[31] Advani et al., 2020.