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Taxation of Trusts

The Finance Act 2006 introduced extensive and surprising changes to the Inheritance Tax treatment of trusts, meaning that many of the differences between the taxation of different types of trusts have now disappeared. There are some transitional provisions for existing trusts. Individuals who are involved with any kind of trust (including provisions for a will trust) should review the existing arrangements to ensure they remain in keeping with the aims of the trust.

The consequence for lifetime Inheritance Tax planning (by means of gifting assets into trust) is that planning will need to be taken much earlier on in life, perhaps by use of the nil rate band every 7 years. The thinking behind trust asset planning may change from thinking ahead one generation to thinking longer term for generations down the line. Nil rate band will trusts set up on an interest in possession basis will continue to be treated as before, but for one generation only. Again, a review of existing arrangements is advisable.

Please note that the below is intended as a broad guide only to a relatively complex area. Additional rules apply to settlor interested trusts (from April 2006, this includes trusts set up in the settlor's lifetime, where the settlor's minor unmarried children can benefit).

Please also see the separate Research Note on Types of Trust, for further details on the practical differences between Trusts.

If you would like to discuss any of the below, or to arrange a meeting with a clarityLAW adviser, please contact your usual adviser, or clarity on:
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Taxation of Trusts - Income Tax

	Income Tax
Bare Trust	Taxed on beneficiary according to their tax position.
Interest In Possession Trust	Trustees account for basic rate tax (7.5% on dividends, 20% on rental, trading and savings income; beneficiary accounts for higher rates if applicable, or can reclaim basic rate tax if a non/starting rate taxpayer).
Discretionary Trust	Income not attributable to a beneficiary is taxed to the trustee rate of tax at 38.1% on dividend income and 45% on other income, with a basic rate band of £1,000. If then distributed, beneficiary can reclaim tax if appropriate.
Accumulation & Maintenance Trust	Income not attributable to a beneficiary is taxed to the trustee rate of tax at 38.1% on dividend income and 45% on other income, with a basic rate band of £1,000. If then distributed, beneficiary can reclaim tax if appropriate.

Notes:
1. Please note that this is intended as a broad guide only – additional rules apply to settlor interested trusts (from April 2006, this includes trusts, set up in the settlor's lifetime, where the settlor's minor unmarried children can benefit).
2. For bare trusts, created after 8 March 1999, where the property is derived from a parent and the beneficiary is aged under 18, an anti-avoidance measure applies in that where the trust generates income in excess of £100 p.a. (per settlor), all of the income is aggregated with the settlor's income for tax purposes.
3. For Discretionary and A&M trusts, if the trust is for the benefit of the settlor's minor unmarried child, income paid to or for the benefit of the child (e.g. maintenance and education) is treated as income of the settlor. However, if income is accumulated then the anti-avoidance rules detailed in the section above under bare trusts do not apply. Payments of capital to or for the benefit of the child are treated as income and assessed on the parent to the extent that the trust has undistributed income.

Taxation of Trusts – Capital Gains Tax

Gains Arising Within the Trust

For bare trusts, capital gains are taxed as if they arise directly on the beneficiary. Parental anti-avoidance legislation does not apply. Any capital gains arising on property transferred by a parent to a bare trust for a minor child are therefore taxable on the child, who can offset their CGT exemption against such gains.

For all other trusts, capital gains arising within the trust are taxed at the trust rate of 20% with no taper relief. In addition, the trust annual exemption of £6,000 (2019/20) is available. This is reduced proportionately where the settlor has created more than one trust, to a minimum of £1,200 (i.e. 5 trusts).

Gains Arising on Transfer of Assets Into/Out of a Trust – Hold-Over Relief

On transfer of assets into a trust, capital gains may arise based on the deemed market value of the assets at that time. However, if the trust is a relevant property trust (see below) then capital gains can be 'held-over'. The base cost on a subsequent disposal is correspondingly reduced by the gain held over. Similarly it is possible to holdover a gain on assets transferred out of a relevant property trust. Therefore, by careful use of such a trust an asset can be transferred between two individuals and the gain held over for CGT purposes both going into and coming out of the trust. The usual rules surrounding settlor interested trusts apply - the settlor must not have an interest in the trust at any time within 6 years of the transfer for hold-over relief to be available.

Please note that CGT hold-over relief is also available for non-relevant property trusts, but only for business assets, agricultural property, heritage property, and donations to political parties.

Gains Arising on Death of a Beneficiary

For a trust where there is an interest in possession, and Inheritance Tax is therefore charged on death of the life tenant, assets are rebased for capital gains tax purposes at the death value.

Please note that this is intended as a broad guide only – additional rules apply to settlor interested trusts (from April 2006, this includes trusts, set up in the settlor's lifetime, where the settlor's minor unmarried children can benefit).

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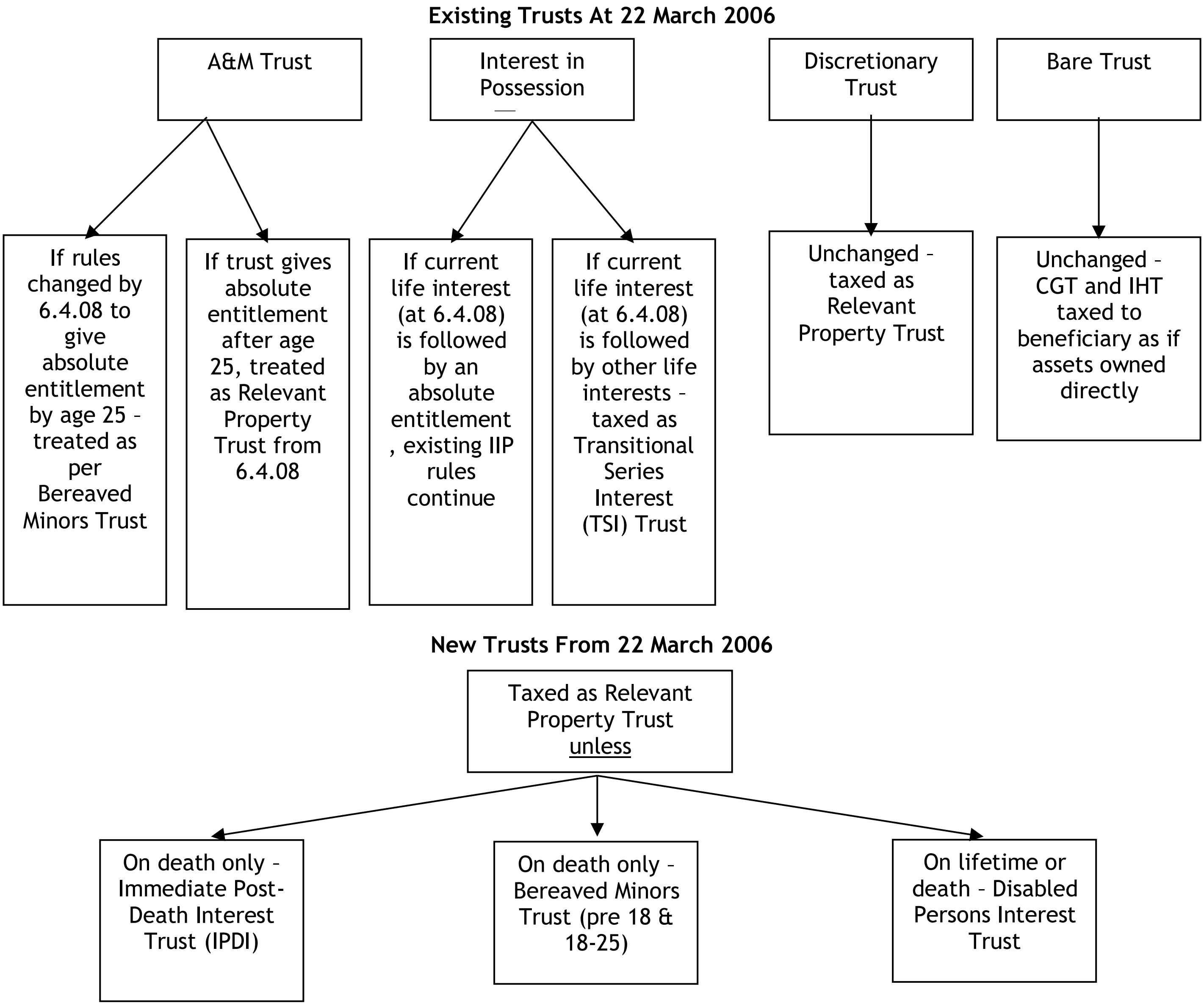
Taxation of Trusts - Inheritance Tax



1. Relevant Property Trusts

Following the sweeping changes to the Inheritance Tax treatment of trusts enacted in the Finance Act 2006, there are now fewer tax differences between the previously more popular types of trusts – ‘Interest in Possession’ and ‘Accumulation & Maintenance’ trusts – and the more flexible ‘Discretionary’ trusts.

The main differences in Inheritance Tax treatment now arise as a result of the type of trust, and also as a result of whether it was a trust created in lifetime or on death. Essentially, all trusts are now treated as **relevant property trusts** (the regime which previously applied only to Discretionary Trusts), unless they fall into one of the following limited categories:

- **Immediate Post-Death Interest Trust (IPDI) -** trusts created on death for the benefit of one person who has a life interest and whose interest cannot be replaced.
- **Bereaved Minors Trust (BMT) -** trusts created on the death of a parent for their minor children, who become absolutely entitled to the assets of the trust by no later than age 25. These trusts will fall into the relevant property regime for exit charges after the beneficiary reaches 18.
- **Disabled Persons Interest Trust (DPI)** - trusts created for disabled individuals, whether on lifetime or death.

For all other trusts, taxed as relevant property trusts, IHT can be charged at the following points:

- Transfers of assets into trust – these are treated as Chargeable Lifetime Transfers, and hence subject to the lifetime rate of IHT (20%) on the value of the transfer above the nil rate band (currently £325,000). When calculating availability of the nil rate band, it is important to take into account previous chargeable transfers.
- Periodic (principal) charges – as there are no absolute beneficiaries’ estates for the trust assets to fall into (and hence for IHT to be charged upon on death of the beneficiary), a periodic IHT charge is made every 10 years. This is at a maximum rate of 6% on relevant property above the trust’s IHT nil rate band.
- Exit (proportional) charges – when capital is transferred out of trust to the beneficiary an exit charge is also made, which represents the portion of the periodic charge payable up to that point ($1/40^{th}$ for each full quarter since the last periodic charge). Where an exit charge arises in the first 10 years (and for the first 10 year charge calculation) the trusts’ ‘relevant property’ includes all chargeable transfers made in the 7 years before the trust’s creation; therefore it is important that accurate records are kept over the long term.

2. Immediate Post-Death Interest Trust

For IHT purposes, the value of the trust fund is treated as being owned by the life tenant. Therefore on the death of the life tenant, the value of the trust fund is added to their other assets (free estate) and subject to IHT to the extent that the total estate exceeds the nil rate band. The trust assets are rebased at the death value for CGT purposes. The tax relating to the trust assets is payable by the trustees.

If the life interest of the life tenant terminates other than on death, e.g. in favour of a bereaved minor trust, or a transitional series interest trust, then this may be treated as a PET.

The spousal exemption continues to apply for IPDIs made in favour of the spouse as the life tenant.

3. Bereaved Minors Trust

For trusts where the absolute interest arises no later than age 18, no entry or exit charges are made, and no charge would arise on the death of a beneficiary. Where the absolute interest arises after age 18, but no later than age 25 (an ’18-25’ trust), no entry charge is made for IHT purposes, but exit charges will apply. The exit charge will be based upon the number of full quarters since age 18, multiplied by 6% of the relevant property above the trust nil rate band. This gives a maximum exit charge of 4.2%, based upon exit at age 25.

4. Trusts Set Up Before 22 March 2006 – Interest in Possession Trusts - Transitional Provisions

These trusts will not fall into the new regime until the current interest in possession ends. If the IIP ends and the assets of the trust pass to another individual absolutely, the old rules apply and there are no IHT implications.

If the IIP ends and the assets stay in the trust, then the assets are included in the estate of the life tenant if the IIP ended on their death (and assets rebased at death value for CGT purposes); if the IIP ended during their lifetime, then the assets are treated as a chargeable lifetime transfer to the ‘new trust’. Periodic and exit charges will then start to apply (unless a charitable trust results). This is now known as a ‘**transitional serial interest’** (TSI) trust.

If the interest in possession in place immediately before 22 March 2006 ended before 6 April 2008, and another replaced it, this will be treated as having been in existence at 22 March 2006.

NB only one TSI change is permitted whilst remaining within the old IIP rules.

The termination of an IIP will also now be treated as a gift from the point of view of the gift with reservation rules, so trustees who may be tempted to change the trust to a full discretionary trust, but with the life tenant retaining any entitlement to benefit, will find that the assets are still treated as part of the life tenant’s estate for IHT purposes.

5. Trusts Set Up Before 22 March 2006 – Accumulation & Maintenance Trusts - Transitional Provisions

These trusts will not fall into the new regime if they were amended before 6 April 2008 so that beneficiaries became absolutely entitled to trust property no later than age 18 (or age 25 for the exit charges to apply as for the age 18-25 trusts above).

Where the beneficiaries become absolutely entitled after age 25, and no modification was made by 6.4.08, then the trust will be treated as a relevant property trust from 6.4.08 with exit charges applying from that date, and the first 10 year charge based upon the date the trust was set up.