Setting the scene

Inheritance tax and trusts



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Emma Florentin-Lee provides a refresher course on trusts

Key Points

What is the issue?

Trusts can sometime seem daunting with different vocabulary and their own tax rules.

What does it mean to me?

Setting the scene on trusts generally and an overview of the tax implications of different types of trust.

What can I take away?

An overview of trusts to increase confidence when discussing trusts and when you come across a client with trust entitlements in practice.

A trust is a separate legal entity, as for example companies are, however the similarity stops there with a new range of vocabulary, tax regimes and implications on beneficiaries to be considered. This article considers the trusts available in the UK and does not cover the taxation of overseas trusts.

The trustees, as a group, are responsible for running the trust, safeguarding of the trust assets and payment of the trusts' tax liabilities. The settlor is the individual responsible for creating the trust and settling the initial assets into the trust. Beneficiaries are the individual(s) who stand to gain from the income or capital (or both) of a trust. Settlors are normally specifically excluded from benefiting from the assets of the trust although this is not always the case. If the settlor (or spouse) can still benefit from the trust this is referred to as a settlor interested trust which is taxed differently from a non-settlor interested trust while the settlor is still alive. The below assumes that the trust is not settlor interested. Further information on how settlor interested trusts are taxed can be found in 'Handbag secrets' in the March 2016 issue of *Tax Adviser*.

The concept of income and capital is very important in the world of trusts. When considering the accounts of a trust the income and capital must be kept separate and expenses incurred by the trustees allocated against trust income or capital as appropriate. Capital normally consists of the initial endowment plus any growth in that capital whilst income is derived from the underlying capital assets.

The powers given to the trustees on creation of the trust can vary and are laid down in the trust deed. A well written trust deed will stipulate how the trustees can use

the capital of the trust and if this can be distributed to income beneficiaries or not. It will also set out the type of trust being created which is very important when determining the tax treatment of the income of the trust and to any potential inheritance tax (IHT) charges which may arise.

The main ‘types’ of trust are as follows:

- *Bare trust*: This is the simplest type of trust and is akin to a nominee arrangement whereby a trustee holds property on behalf of the beneficiary while the trustee acts in accordance with the beneficiary’s wishes. The trustee has no power of discretion and the beneficiary is absolutely entitled to the trust property.
- Interest in Possession trust (IIP): The beneficiaries, sometime referred to as life-tenants are absolutely entitled to the income of the trust as it arises (net of income tax and the income expenses of the trust). There is normally a remainder man who is ultimately entitled to the capital of the trust when the income beneficiaries are no longer entitled to income, e.g. on death or if they have reached a specific age set out in the trust deed etc.
- *Discretionary trust (DT)*: The trustees are given discretionary powers to determine the level of income (and sometimes capital) to be distributed and to which beneficiary/ies from the pool of potential beneficiaries.
- *Accumulation and Maintenance trust*: Under the trust deed the terms of the trust will change for a beneficiary at a specified age at which he must become entitled to an IIP in his share of the trust capital or be entitled to the capital absolutely. These trusts are therefore treated and taxed as DTs until the beneficiary reaches the specified age at that point they are either wound up if the beneficiary becomes absolutely entitled to their share of the trust assets or continued as an IIP and taxed under the IIP rules accordingly. Since 22 March 2006, these can no longer be created.

We will now look at the ongoing taxes applicable to trusts. There are specific tax consequences upon creation of a trust but for further information about creating a trust see the article ‘Trusted solution’ in the July 2015 issue of *Tax Adviser*.

Income tax

Trustees pay income tax on behalf of the trust on the trust income and capital gains under self-assessment with the same filing deadlines and payments on account rules

as for individuals. The tax computation however, will look rather different. Trustees responsibilities for paying the trust taxes are kept entirely separate from their own personal tax affairs.

An IIP's trustees will pay basic rate tax on the trust's gross income received in the tax year, regardless of the level of income received by the trust. Trustees are not allowed tax relief for the income expenses of the trust, however, these are taken into account when reporting the distributions made to the beneficiaries (see below).

The added level of flexibility DT trustees enjoy comes with an increased tax cost. Trustees of DTs pay tax on their income at the rate applicable to trusts (RAT) which is currently aligned with the additional rates for individuals. The various personal income tax bands do not apply to income taxed using the RAT. Income used to cover the trust's income expenses and the first £1,000 of gross income received by the DT trustees is only taxed at the basic rate.

The income tax situation of DTs is further complicated by the need to maintain a tax pool which is a running total of the tax paid by the trustees less any tax used to frank income distributions. This must never be allowed to go negative and in situations where the credits used to frank income distributions are in excess of the running total of tax paid by the trustees, the tax pool must be 'topped up' by the trustees by way of a further income tax pool charge.

Trustees of both IIPs and DTs are responsible for preparing annual R185 forms in years where there have been income distributions. These must be passed to the relevant beneficiaries as they detail the income distributions made to the respective beneficiary in the year along with the associated tax credit. These forms are the evidence required for HMRC to allow the beneficiary to claim the tax credit against his income distribution.

Once in the hands of the beneficiary IIP distributions are taxed on the beneficiary at their marginal rates keeping their underlying income type, i.e. income, dividends or non-savings. If the taxpayer is a higher or additional rate tax payer, further tax will be due on the income distributions.

Discretionary distributions are always taxed on the beneficiary as non-savings income regardless of the underlying income type. Given the rates of personal tax and trust tax are now aligned there will never be any further tax to pay by the beneficiary on receipt of an income distribution from a discretionary trust, in fact

there may be a tax repayment depending on the beneficiary’s level of other income.

Capital Gains tax

Both IIPs and DTs pay capital gains tax on capital gains made in the year. The capital gain is calculated in exactly the same way as it would be for an individual and rates of CGT payable by a trust are the same as for individuals however, trustees are only entitled to half the ‘normal’ annual exemption.

Trustees may also be liable for CGT when capital assets of the trust are appointed to a beneficiary. The deemed disposal value will be the market value of the asset at the date of transfer. The normal CGT rules apply for calculating the gain and the resulting gain will be taxed in the same way as gains made on the sale of assets by the trustees discussed above.
Inheritance tax

Inheritance tax is very important to consider when dealing with trusts. The inheritance tax regime for trusts varies depending on the type of trust you are dealing with.

IIP trusts will either be qualifying or ‘non-qualifying’ and the IHT treatment differs depending on the type of trust.

To be a qualifying IIP the trust:

1. Must be set up for the benefit of a disabled person
2. Be created on death via a Will
3. Created prior to 22 March 2006

Trust assets of a qualifying IIP will be treated as part of the beneficiary’s estate and IHT will be paid on the trust assets on the death of the beneficiary in the normal way. There will be no ongoing IHT considerations for the qualifying IIP.

No part of a DT falls within the estate of any of the beneficiaries. All DTs and ‘non-qualifying’ IIPs are classed as ‘relevant property trusts’. Assets in relevant property trusts escape IHT in the hands of the beneficiary therefore HMRC levy periodic IHT charges on the trustees on each 10-year anniversary of the creation of the trust. Calculation of these charges is complex and not within the scope of this article but applies a rate of IHT up to 6% of the value of the trust assets. There are also IHT

charges when capital assets leave the trust either via a capital distribution or on a beneficiary’s entitlement to trust capital. Note that normal income distributions, whether from an IIP or DT, do not trigger any IHT charges.

Residency

The above assumes the trust is a UK resident trust. A trust will be resident in the UK for income tax and CGT purposes if either:

1. All trustees are UK resident
2. At least one trustee is UK resident and the settlor was domiciled or resident in the UK at the time they made the settlement.

Trusts are only subject to IHT if the settlor was UK domiciled when setting up the trust or if the trust own UK situs assets.