

# The basics of trust taxation

*Penny Bates* looks at the tax rules for the new relevant property trusts, plus some of the old ones

There are a number of differing types of trust commonly used in tax planning, including interest in possession (also commonly known as life interest), discretionary, vulnerable persons and bare trusts. Apart from a bare trust, which effectively means that assets are held for someone by a nominee, the various trusts are subject to their own rules covering income and capital taxes.

A major change was introduced in the *Finance Act 2006*, which effectively ended the distinction for inheritance tax between the types of trust, so any new trust is a relevant property trust for inheritance tax (previously known as a discretionary trust). These changes had fairly far-reaching effects on accumulation and maintenance trusts, and introduced a number of new 'specialist' trusts, eg, bereaved minors.

This article will briefly look at the tax rules for the new relevant property trusts and the continuing rules in respect of the old interest in possession trusts regime, since many of these will continue for a number of years to come.

## Interest in possession trust (IIP)

**Definition:** a present right to income or present enjoyment of trust assets – ie, the life tenant (the beneficiary) is entitled to receive the income as it arises, or enjoy use of the assets.

The following old rules continue to apply to all IIPs in existence at 22 March 2006.

**Income tax** – the trustees are responsible for paying basic rate liability to the Revenue. The beneficiary is provided with an R185 certificate showing details of the trust income and associated tax credit, which he then returns on his self-assessment. Depending on the level of his other income he may be entitled to a repayment, or have a further liability to pay (see Example, above right).

**Capital gains tax** – on the life tenant's death there is no CGT payable because the assets are uplifted at that date (see below re IHT charge). This is the same as if he held the assets personally. (There are special rules for assets held by the trust, on which a claim to holdover relief was made, when they were acquired by the trustees.)

If the beneficiary were to become absolutely entitled to the assets during his lifetime, this would be a deemed disposal by the trustees at market value and they would be responsible for paying any CGT liability arising as a result. The trustees are entitled to an annual exemption equal to one half of the personal annual exemption, but this is further divided where the

### Example

Trustees received net rental income of £2,000 and gross savings income of £500. They are responsible for the basic rate liability as follows:

Rental income £2,000 x 20 % = £400  
Savings income £500 x 20% = £100

The R185 certifies this income and tax credit.

The beneficiary makes a return to the Revenue. His other income is a state pension of £5,000 and he is entitled to the full age allowance of £9,180 for 2008/09. His tax position is:

State pension	5,000		
Rental income	2,000	Tax	400
Savings	500	Tax	100
	<u>7,500</u>		<u>500</u>
Less PA	(9,180)		

No tax liability as allowances exceed income, so the full tax credit of £500 is repayable.

settlor has created more than one trust with a minimum allowance per trust of 1/5<sup>th</sup>.

**Inheritance tax** – a number of these trusts existed at 22 March 2006 when the *FA 2006* changes came into effect, and they will continue to be taxed under the 'old rules' for inheritance tax. On death the value of the trust assets is aggregated with the beneficiary's free estate and subject to IHT. This is because for IHT purposes the beneficiary is treated as the absolute owner of his interest in the trust.

The *FA 2006* rules introduced the concept of a transitional serial interest. Where a life interest comes to an end before 5 October 2008, in respect of a trust created before 22 March 2006, and another life interest comes into existence, the old rules will continue to apply. This will also be the case where after 5 October 2008, the life tenant dies and the spouse or civil partner is entitled to another life interest.

If the life interest ends and the trust does not terminate or is not a new life interest as described above, then the trust will be taxed

under the relevant property trust rules (see table below).

With effect from 22 March 2006 it is no longer efficient from an IHT perspective to create an IIP trust, since it will not be treated as part of the beneficiary's estate but rather will fall within the relevant property trust regime for IHT purposes.

## Relevant property trusts (RPT)

Before the *FA 2006* changes these were generally known as discretionary trusts. The majority of new trusts now created will fall within this regime – exceptions include bereaved minor's trusts and immediate post-death interest trusts, which cannot be looked at in the space allowed for this short article. A RPT does not generally have a nominated life tenant but more usually a specified class of beneficiaries, none of whom have an immediate interest in the trust. Their interest is subject to the discretion of the trustees, who may or may not decide to make distributions of income.

### Summary table – IIP – main tax rates

Income tax		Dividend or savings rate as applicable
CGT	On death of life tenant	No CGT (except where holdover relief was claimed)
	Disposal other than death	Chargeable disposal by trustees – max half personal annual exemption and tax charged at 18%
IHT	On death	Aggregated with beneficiary's free estate
	Surrender of life interest by life tenant	Potentially exempt transfer

**Income tax** – the trustees are responsible for tax at the rate applicable to trusts, being 40% except in the case of dividend income, where the rate is 32.5%. A standard rate band of £1,000 applies to trust income (see Table 1, right).

It is clear from the above example that the tax available to credit the distribution is sufficient, but it is likely there is unused credit in the tax pool from earlier years. The tax pool consists of tax not used in the past to 'frank' payments of income to beneficiaries. The purpose is to ensure that all distributions carry the correct tax credit.

**Capital gains tax** – The trustees are liable to CGT on all disposals they make subject to the trustee's annual exemption and payable at 18%. However, holdover relief is generally available whatever the nature of the asset under the post-22 March 2006 regime under IHTA 1984, s. 260 on assets transferred into or out of a RPT.

**Inheritance tax** – On creation during lifetime of the settlor there is an IHT charge at a rate of 20%, except to the extent that transfers do not exceed the nil rate band. Relief is available under the business property and agricultural property rules where the relevant conditions are met. Should the transferor die within seven years of creating the trust, the tax rate is increased to the full 40%.

Trusts within the RPT regime have their own nil rate band for IHT purposes, with tax being charged every 10 years at a maximum rate of 6%. Where assets leave a trust in the intervening period, the maximum charge is reduced by reference to the complete number of quarters that the asset has been relevant property of the trust.

The first 10-year charge is calculated by reference to the settlor's chargeable transfers before the creation of the trust, plus any capital distributions in the first 10 years and the value of the fund at the 10th anniversary (see Table 2, right).

Following the initial 10-year charge the next 10-year charge is based on the effective rate of the last anniversary, but taking into account the nil rate band at the time of the later 10-year charge. Additionally, charges can arise in the intervening periods if assets are appointed from the trust subject to a reduction in the charge as mentioned earlier (see Table 3, right).

## Summary

I have always found working with trusts to be an interesting and sometimes challenging area of tax. The above is a rather brief summary of some of the main rules to act as a refresher only. There are many detailed rules that add to the interest of working in this area of tax.

**Table 1**

### Example

Taking the same income figures (Rents £2,000; Gross interest £500) as in the IIP example above, the trustees' liability to tax would be as follows:

Rental income (standard rate band £1,000)	1,000 x 20% = £200
Balance of trust income at 40%	1,500 x 40% = £600

Trust management expenses have been ignored for sake of simplicity.

The trustees' net income would therefore be:

Income	£2,500
Less tax	(800)
	<u>£1,700</u>

The trustees decided to make a net distribution of income to one of the discretionary beneficiaries of £1,000

The R185 figures are    Net £1,000    Tax £666.66    Gross £1,666.66

**Table 2**

A simple **example** will illustrate this:

Trust created on 31 March 1998. Value of fund at 31 March 2008 is £600,000. Distributions of £50,000 have been made in the first 10 years and the transferor made previous lifetime transfers of £50,000.

Previous chargeable transfers of settlor	50,000
Distributions in first 10 years	50,000
Value of fund at anniversary	600,000
	<u>700,000</u>
Nil rate band at 31.03.08	(300,000)
	<u>400,000</u>
IHT at 20% (lifetime rate) on £400,000	£80,000
Effective tax rate 80,000/600,000 = 13.3%	
Tax rate 30% of effective rate 13.3% = 3.99%	
Tax payable on trust assets £600,000 x 3.99% = £23,940	

**Table 3 Summary table – RPT – main tax rates**

Income tax		Rate applicable to trusts – 40% except for dividends which are taxed at 32.5% – standard rate band on first £1,000 of income
CGT	Disposal by trustees	Chargeable disposal by trustees – max half personal annual exemption and tax charged at 18%. Possibility to hold over under s. 260 where assets appointed out of the trust
IHT	On creation	Chargeable transfer subject to tax at 20% where transferor's nil rate band exceeded
	Tenth anniversaries	Maximum IHT charge at 6%
	Distributions between 10th anniversaries	IHT charge under RPT regime but limited to the complete quarters that the property has been relevant property.

Hopefully, the forgoing gives a brief overview of some of the main rules for practitioners not dealing with trusts on a regular basis and students trying to get to grips with them. I recall when I was learning about trusts that I was told to think of them as a 'bloke called Trevor' who had his own tax rules to follow – it helped me!!

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