

# TRUSTS

APRIL 2024

Trusts can be very useful where you wish to retain some **control** of assets, which can also combine with **Inheritance Tax planning**. They are also necessary where the **beneficiary is under 18** and cannot yet legally hold assets themselves.

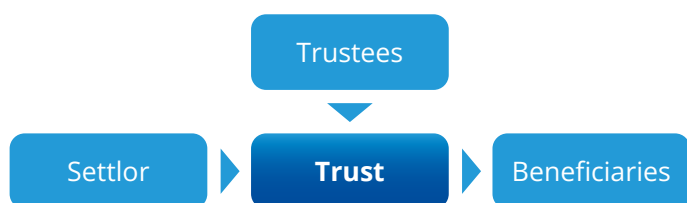
Many, if not most, trusts **must now be registered with HMRC** and there are potentially hefty fines for failing to do so. New trusts have 90 days to register.

The Finance Act 2006 introduced extensive 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 were transitional provisions for trusts existing at that time, which should be reviewed to ensure they remain in keeping with their original aims.

The taxation of trusts is not always easy to understand, and we cover the main details here. However, we suggest that you take professional advice in this potentially complex area.

# WHAT IS A TRUST?

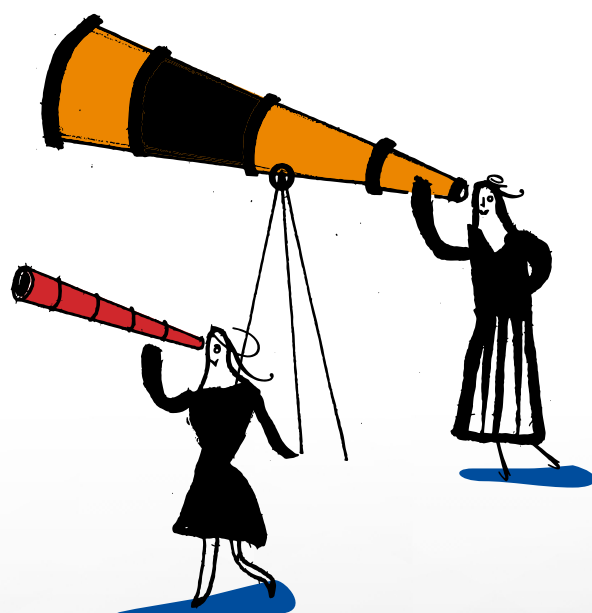
A trust is a relationship created when a **settlor** transfers property to a **trustee** directing them to account for the benefit of that property according to the **trust deed**, normally to **beneficiaries** designated by the settlor. Trusts (other than bare trusts, where the beneficiary cannot be changed), are often also known as **settlements**.



It should be noted that the concept of a trust is a common law concept and therefore not universally recognised. Some countries, notably France and Spain, are civil law jurisdictions and do not recognise trusts. Care is therefore needed where property located in a civil law jurisdiction is subject to trust as the concept will not be recognised on death of the settlor or beneficiary and property may not pass in accordance with any trust documentation. Furthermore, property located in these jurisdictions may be governed by “forced heirship” rules with a certain percentage passing to defined beneficiaries irrespective of the wishes of the deceased.

The concept of trust is based on two types of interest in property. Whenever the **equitable interest** and **legal titles** in a piece of property do not belong to the same person there will be a trust:

- The common law or legal title belongs to the person whose name is on the title deeds to land or the share certificate of a company (the **trustee**). This individual is the person who will affect any necessary formalities – for example they will sign the documents to transfer the property to a purchaser.
- The equitable or beneficial title belongs to the person who is entitled to derive the real benefit from the property (the **beneficiary**).



# TYPES OF TRUST

The following categories are commonly used to describe the general structure or aim of the trust:

## BARE OR ABSOLUTE TRUST

This is not really a trust at all, but rather an arrangement where the beneficiary has an absolute entitlement to the underlying property and the trustee merely holds the property on behalf of the beneficiary, effectively as a nominee. Often bare trusts are used where ownership of shares or units in a unit trust are held by an adult on behalf of a minor.

## DISCRETIONARY TRUST

A discretionary trust is a flexible trust where no individual beneficiary has a right to the income of the trust. Whether or not they receive capital or income is entirely dependent on the discretion of the trustees, hence the selection of the trustees is very important. Discretionary trusts are very flexible as trustees can make distributions to reflect the changing financial circumstances of the beneficiaries.

## INTEREST IN POSSESSION TRUST

This is a trust under which one or more beneficiaries are entitled to income from the trust fund as an absolute right. The trustees have no discretion as to whether income is distributed. The income beneficiary is said to have an **"interest in possession"** or is sometimes referred to as the **"life tenant"**.

Typically the life tenant will have a right to income for a fixed period, usually their lifetime, and then capital will be distributed in accordance with the trust deed to the **"remainderman"** or another interest in possession will commence.



# TYPES OF TRUST

## ACCUMULATION AND MAINTENANCE (A&M) TRUST

An A&M Trust is a discretionary trust (see above) where one or more beneficiaries will become legally entitled to the income, or both capital and income, of the trust on attaining a specified age of not more than 25. A&M trusts are generally used to benefit children or grandchildren of the settlor. Until then, the income can either be accumulated, or it can be used by the trustees for the maintenance, education or benefit of any of the potential beneficiaries. The trust must last in this form for no longer than 25 years, or must be for the benefit of grandchildren of a common grandparent. The favourable tax treatment of this type of trust no longer applies to trusts set up following the Finance Act 2006.

## OTHER TYPES OF TRUST

### Flexible Power of Appointment Trusts

These are a hybrid between discretionary and interest in possession trusts. For tax purposes they are treated as interest in possession, as an individual or number of individuals will have an absolute entitlement to trust income. However, trustees also have discretion to appoint or vary beneficiaries and to make appointments of capital to beneficiaries thus giving the trusts the flexibility associated with full discretion.

### Offshore Trusts

Offshore trusts are structured in the same way as onshore trusts and are typically located in centres with established trust expertise, e.g. the Channel Islands. Complex tax rules apply, introduced over many years to counter the wide-scale use of such trusts to avoid tax. However, these are outside of the scope of this summary.



# INCOME TAX

## Income Tax

### Bare Trust

Taxed on beneficiary according to their tax position.

### Interest In Possession Trust

Trustees account for basic rate tax (8.75% 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 39.35% on dividend income and 45% on other income. 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 39.35% on dividend income and 45% on other income. 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.
- 4 Since 6 April 2024, the trust basic rate band no longer applies. Instead, trusts with income under £500 pay no tax. All other trusts pay tax at the trust rate on the whole amount of income received. If a settlor has more than one discretionary or A&M trust, the £500 limit is split between them, down to a minimum level of £100 per trust. Beneficiaries receiving income within the £500 limit are also exempt from tax on this income

# 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 £1,500 is available. This is reduced proportionately where the settlor has created more than one trust, to a minimum of £300 (i.e. 5 trusts).

## 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.

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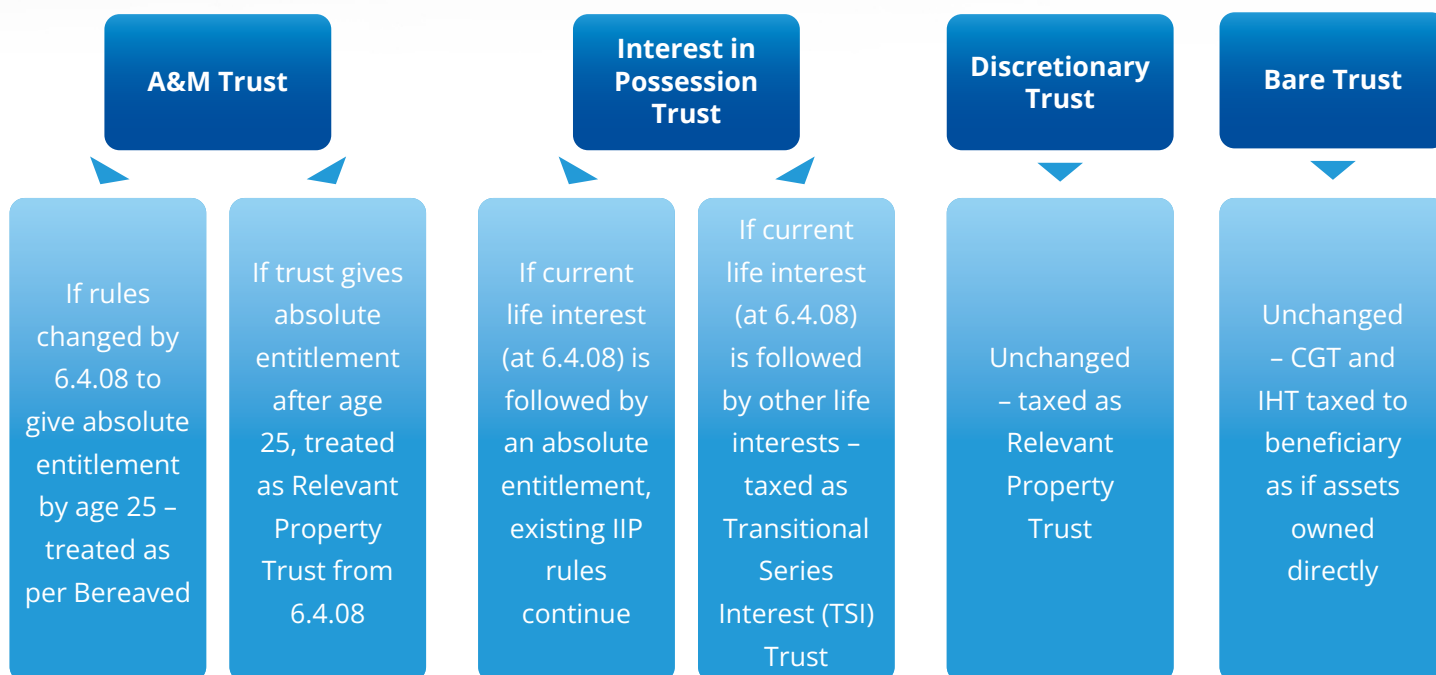
## GAINS ARISING ON TRANSFER OF ASSETS INTO/OUT OF A TRUST - HOLD-OVER RELIEF

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.

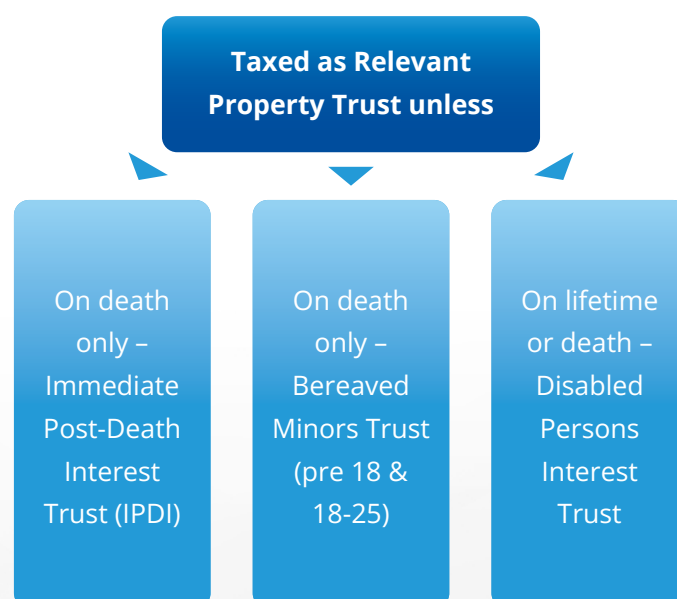
Please note that CGT hold-over relief is also available for non-relevant property trusts, but only for business assets, agricultural property, heritage property, and donations to political parties.

# INHERITANCE TAX

## EXISTING TRUSTS AT 22 MARCH 2006



## NEW TRUSTS FROM 22 MARCH 2006



# INHERITANCE TAX

## 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 (1/40th 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.



# INHERITANCE TAX

## 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.

## 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.



# INHERITANCE TAX

## 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.

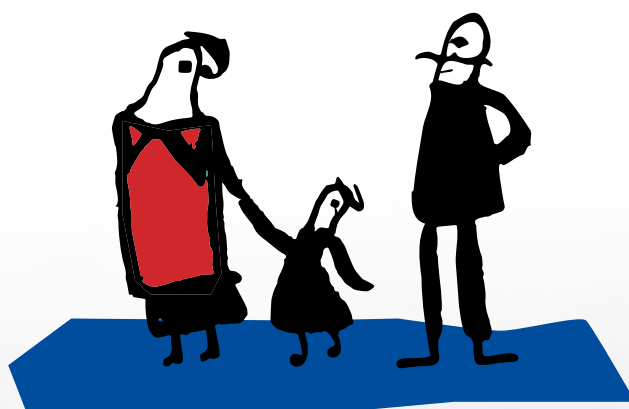
NB only one TSI change is permitted whilst remaining within the old IIP rules.

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.

### 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.



# FIND OUT MORE

If you have any questions about our investment methodology, or would like some financial planning or investment advice, the clarity team are here to help.

Please contact your usual clarity adviser, or get in touch using the details below:

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