AF1/J02
Part 4: Taxation of Trusts (1) 2023/2024
Introduction, Bare Trusts and CGT

The next five parts will cover the taxation of trusts. Since it is a complex subject we will deal with it in separate parts. This first part will take an overview of the tax regime, the taxation of Bare Trusts and then focus on capital gains tax for both IIP and Discretionary Trusts.

The following parts will cover.

- Income tax for IIP trusts
- Income tax for Discretionary Trusts
- The Tax treatment of life policies in trust
- The IHT treatment of trusts

The milestones are to understand:

- The way tax impacts on trusts.
- How a Bare Trust is taxed
- How capital gains tax impacts on IIP and Discretionary Trusts.

Overview

Tax can impact on the three parties to a trust in different ways.

<u>Settlor</u>

When the settlor makes a lifetime gift into the trust this will be subject to IHT being either an exempt, potentially exempt or a chargeable lifetime transfer. Further gifts into the trust will also come under the scope of IHT.

Making a gift into a trust may also give the Settlor a Capital Gains Tax liability if he or she transfers assets that have a higher value at time of transfer than when they were acquired.

<u>Trustees</u>

Trustees have a duty to invest the assets and any income or gains will be subject to tax. Except for a Bare/Absolute trust, the trustees are responsible for declaring and paying this. The trust is a legal entity, so the trustees' liability is separate from their own tax position. However, should the trust owe tax and there was insufficient money in the trust to pay it, the trustees would have to pay this from their own pockets.

Beneficiaries

When money or assets are distributed from the trust, the beneficiary may have a tax liability. The general rule is that beneficiaries will always be liable to income tax on any income they receive from the trust but can offset tax paid by the trustees.

Beneficiaries are not normally liable for any Capital Gains Tax when they are given an asset by the trust but will be liable when they sell or dispose it.

Bare/Absolute Trusts

In this type of trust, the beneficiaries have the right to demand the trust property is given to them at any time. Consequently they are personally liable for tax on any income produced by the trust and can use their personal allowance, personal savings allowance together with their dividend allowance.

Income from a bare trust is subject to the parental income rule so if the trust property was a gift from the parents any income of more than £100 is deemed to be the parents rather than the child's. If the trust was set up by anyone else, e.g. the grandparents, all the income is deemed to be the child's who can use his or her personal allowance.

They are also liable for any gains made on disposal of trust assets and can use the full annua exemption. They will be charged at either 10% or 20% depending on their tax status. (18% & 28% if residential property.

On death of the beneficiary the trust is included in their estate.

Capital Gains Tax

CGT could impact on both the settlor and the trustees.

- If the settlor makes a **lifetime** gift into a trust it will be a disposal for CGT.
- When the trustees dispose of an asset within the trust it could be subject to CGT

CGT does not arise when assets are transferred on death since any individual CGT liability is wiped out on death.

CGT on IIP and Discretionary Trusts

The rules for these are the same.

When the trustees dispose of an asset, the gain is calculated in the normal way but the trust's CGT allowance is ½ of the normal allowance, i.e. £3,000. If the settlor sets up more than one trust the CGT exemption is shared between them subject to a minimum allowance of £600.

The rate is 20% or 28% for residential property. However the trustees can claim PPR relief if the beneficiary had a right to live in the property.

Amy is the life tenant of her late husband's IPDI trust which gave her the right to live in the marital home. She has had to move into a care home and the trustees decide to sell the property. No CGT would be payable.

A liability could also arise if assets were transferred from the trust to a beneficiary. The trustees are then liable for the gain made between acquisition and disposal.

CGT and Holdover Relief

Gains made by the settlor on gifting property together with gains made by the trustees when giving property to a beneficiary can be mitigated by using holdover relief provided it is a **Relevant Property Trust.**

A discretionary trust is always relevant property. All trusts created since 27 March 2006 are Relevant Property except for:

- Bare Trusts
- Immediate Post Death Interest Trusts
- Bereaved Minor Trusts

In addition, all IIP trusts set up before 22 March 2006 where there hasn't been change of beneficiary since October 6 2008 will be classed as non-relevant property trusts.

The significance of this as regards CGT is that if a settlor makes a gift into a relevant property trust **holdover relief** is available. This is not available for a non-relevant property trust.

Ben gifts shares with a value of £50,000 that he acquired for £10,000 into a bare trust. He will be liable for CGT on the gain of £40,000. The trust will have acquired them at a value of £50,000. If he had gifted the shares to a discretionary trust, he could have asked the trustees to use holdover relief. If they agreed, he would not be liable for any CGT but the trust would have deemed to have acquired them at £10,000.

Moreover, if it is a relevant property trust holdover relief can also be used when gifting property to a beneficiary provided both trustees and beneficiary agree to this. The trustees will not have a tax liability and the beneficiary is deemed to have acquired the assets at the price at which the trustees acquired them rather than the price at transfer. This can be advantageous since the beneficiary would have the full annual exemption and may only be liable to tax at 10%

The trustees of an IIP trust decide to pass unit trusts showing a gain of £20,000 to Sam, a beneficiary of the trust who is a basic rate tax payer. If the trustees pay the tax they would be liable to (£20,000- £3,000) @ 20% = £3,400.

If holdover relief were claimed and Sam were immediately to sell the unit trusts, his liability would be (£20,000 -£6,000) x 10% = £1,400 Sam could also decide to dispose of just enough to use his annual exemption and avoid tax completely

If the beneficiary of an IIP dies and the trust winds up, the assets within the trust are valued at date of death but there is no CGT liability on the trustees or deceased beneficiary.

Payment of CGT is due by the 31st January following the end of the tax year in which the gain was made. Gains on the sale of residential property must be paid within 60 days of completion.

That concludes this part so you should now understand:

- The way tax impacts on trusts.
- How a Bare Trust is taxed
- How capital gains tax impacts on IIP and Discretionary Trusts.

Further Reading

https://www.gov.uk/guidance/trusts-and-capital-gains-tax