AF1/J02
Part 4: Taxation of trusts (4) 2023/2024
Insurance Policies in Trust, VP and Settlor Interested Trusts

The last two parts looked at how the three main trusts are taxed as regards income and capital gains. There are though some exceptions to these rules.

This milestones are to understand:

- The taxation of Investment Bonds held in a trust.
- The tax rules for a vulnerable person's trust.
- The tax rules for a settlor interested trust.

It should be stressed that the last two are not different types of trust. They will either be an IIP or a discretionary trust. The tax rules change because of the status of the beneficiary. Similarly, Investment Bonds can be held in in all three types of trust but they are taxed in a unique way.

Investment Bonds in trust

Investment Bonds are popular investment vehicles for trustees of IIP and discretionary trusts. As different funds can be held within one bond, trustees can diversify investments within a single product. They also reduce the trustees' tax administration because tax on an IB only becomes due when there is a chargeable event. The fact that it is in a trust does not change this principle.

Kate has set up a discretionary trust for her grandchildren with the intention that the trust capital should be used to fund their higher education. The trustees have invested in a range of OEICs. The trustees must complete a tax return each year and pay tax on income as it arises. If they switch their holding, say to reduce risk in later years, CGT may be payable.

Bill has set up a similar trust with the same objective. The trustees have taken out a single IB split into a range of different funds. There probably won't be a chargeable event until the capital is transferred to the beneficiaries so they do not need to complete a tax return until that happens. Switching funds is not a chargeable event.

Although an Investment Bond does not produce an income this does not change the status of an IIP trust since the beneficiaries only have a right to income. Should the trustees wish to provide the beneficiaries with regular payments they could use the 5% withdrawal facility. Provided that no more than 5% of the original investment is withdrawn in a plan year there is no chargeable event.

Tax on Chargeable Events

If an Investment Bond is held in a bare trust liability falls on the beneficiary. For IIP and Discretionary Trusts there is a priority order to establish who is liable to pay the tax. This is:

1. The Settlor if he or she is alive in the tax year the chargeable event occurs and was UK tax resident.
2. UK resident Trustees
3. Beneficiary

When a chargeable event takes place, any tax will be assessed in the first instance on the settlor provided they are UK resident and are still alive. It will also be assessed on the settlor if the chargeable event took place in the tax year of their death. This will be charged as if they were the direct owner, they can use top slicing and recover the tax from the trustees.

If the policy was taken out before 17 March 1998 and the settlor died before that date, then no one is liable for the tax. This is known as the "dead settlor trick".

If this rule does not apply and the settlor is dead or not UK resident, then the trustees are liable (provided at least one is UK resident). The rate chargeable is 45% although 20% is deemed to have been paid within the bond. The trustees can utilise the "basic rate band" for the first £1,000 that we came across with Discretionary Trusts

If the trustees aren't resident, then any UK beneficiary is liable at his or her tax rates. They cannot use top slicing.

In practice it is quite easy to avoid these situations. The trustees should gift all or part of the bond to the beneficiaries by assignment.

Yolanda is a potential beneficiary of her late grandmother's discretionary trust. The trust property is an Investment Bond that is split into segments.

On Yolanda's 21st birthday the trustees wish to give her £20,000. If they encash segments to give her cash, then the trustees would be liable for tax as the settlor died after 17th March 1998.

Instead the trustees assign sufficient segments to her. Since Yolanda has not paid any money for this it is not a chargeable event and the trustees have no liability.

Yolanda can then surrender the segments and this would be taxed on her own situation.

The disadvantage of an onshore bond is that the tax paid within the fund cannot be recovered.

If the trustees had invested in an offshore bond no UK tax would have been charged on the underlying investments. The beneficiary is liable to pay tax on all the gain but can offset her Personal Allowance and PSA as in the following because whilst chargeable gains are taxed after savings and dividend income, they are treated as savings income.

In the tax year Yolanda receives the £20,000 (23/24, her only income is from vacation work which amounted to £9,570. She decides to encash all the segments.

The "gain" on the offshore bond is £15,000 so it is all taxable. £3,000 of this will be absorbed by her remaining Personal Allowance

As she has no savings or dividend income the gain is the next slice of income to be taxed. It is treated as savings income so she can use the £5,000 0% rate band together with £1,000 PSA.

The result is that only £6,000 of the gain is taxed. The rate is 20% so her liability is £1,200.

Protection policies held in trust

It is good policy to place protection policies written on an own life basis to be placed into a trust.

On the death of the life assured the trustees would make the claim and pay the proceeds direct to the beneficiaries. This avoids the probate process (and IHT as the policy is not included in the deceased's estate) which also means the payment can be made very quickly.

To make the claim the trustees must provide the insurer with

- The deceased's death certificate
- A copy of the Trust Deed
- The policy document
- Deeds of appointment or retirement of trustees
- A claim form
- Money Laundering ID

Trusts for vulnerable Persons

These may also be called a disabled person's trust. It should be stressed that this is not a new type of trust. It is normally a discretionary trust where a beneficiary is entitled to be classed as a vulnerable person. This has the effect of changing the calculation of both income and capital gains tax. Effectively both income and gains will be taxed on the beneficiary's own tax position.

Who is a vulnerable person?

This is either:

- A Bereaved Minor, that is a child under 18 who has been predeceased by at least one parent.

- OR a “disabled person” which is defined as:
- Someone who by reason of “mental disorder” within the meaning of the Mental Health Act 1983 is incapable of administering their property or managing their affairs.

OR someone who qualifies for:

- Personal Independence Payment
- A disablement pension.
- Constant Attendance Allowance
- Armed Forces Independence Payment

The individual does not need to claim or be receiving these benefits, if their state of health would mean they qualify for them they can be treated as VPs.

Trusts qualifying for special treatment

To qualify for this treatment, the assets must only be capable of being used to benefit the minor child or disabled person whilst they are alive. The person must be entitled to an income from the trust and if they are not entitled, as in a discretionary trust, none of the income can be applied to anyone else.

Capital can be advanced to other beneficiaries up to the lesser of £3,000 or 3% of the trust capital each tax year.

Making a Vulnerable Person Election

To get the special tax treatment the trustees must complete form VPE1 and send it to HMRC. It must be signed by both the trustees and beneficiary (or someone who can legally sign for the beneficiary). The special tax treatment starts at the date chosen on the form and must be made no later than 12 months after 31 January following the tax year when it is to start.

The trustees have decided to apply for vulnerable status for a beneficiary. This is to start on April 2020. The last date to complete the form will be January 31 2022

The decision is irrevocable and will come to an end on the death of the beneficiary or in the case of a bereaved minor, reaching 18

A further benefit of making a VP election with a Discretionary trust is that any payments should not affect their entitlement to state means tested benefits. However, care should be taken that any property is put into the trust rather than being first given to the beneficiary. The latter might result in state benefits being lost as they might be deliberate deprivation of assets,

Calculating Income Tax

This is a three stage process.

- The trustees calculate their income tax liability without the VP election (a)
- The trustees calculate the income tax the VP would receive if the trust income had been paid directly to the beneficiary (b)
- The difference between the two (a-b) is then deducted from the amount the trustees have to pay.

Peter is a vulnerable beneficiary. The trust is a discretionary one. The income of the trust is:

Interest, £10,000,
Dividends, £20,000

Trust tax calculation

Interest	£1,000 @ 20%	£200
	£9,000 @ 45%	£4,050
Dividends	£20,000 @ 39.35%	£7,870
		£12,120

Individual calculation

Interest	£10,000 @ 0%	0 (absorbed by PA)
Dividends	£2,570 @ 0%	0 (absorbed by PA)
	£1,000 @ 0%	0 (Dividend allowance)
	£16,430 @ 8.25%	£1,355.48
Total		£1,355.48

Trustee's liability	£12,120.00
Individual liability	(£1,355.48)
	£10,764.52

Final trustee liability	£12,120.00
Less	£10,764.52
	£1,355.48

Calculating Capital Gains

The same process applies.

1. The trustees calculate the CGT they have to pay using their annual exemption and the 20% rate
2. They work out the tax the beneficiary would pay using their full annual exemption of £6,000 and their own CGT rate.
3. The difference between the two is then deducted from the trustee's liability

Settlor Interested trusts

Again this is not a new type of trust but is an amended tax regime if the settlor or spouse can benefit from the trust. It dates from a time when the higher income tax rates for individuals were greater than the rate for trust investments and was an anti-avoidance measure.

A trust is classed as settlor interested if either the settlor or their spouse can benefit from the trust. Trust wordings will usually be written to avoid this happening. A widow or widower of the settlor can benefit without it being classed as a settlor interested trust.

Mrs Brown sets up a Discretionary Trust. If her husband Mr Brown can benefit it is a settlor interested trust. If the wording allows him to benefit only on her death it is not a settlor interested trust.

A spouse does not include a settlor's future spouse, a separated spouse or a former spouse.

Tax calculation

If there is a settlor interest the whole of the trust income is taxable in the hands of the settlor even if this is not paid to them.

- The trustees will prepare their tax return as normal
- The settlor must declare all the income on their tax return.
- In the hands of the settlor, the income retains its character, and entered on the settlor's return as either non-savings, savings or dividend income.
- The settlor can use their PSA and dividend allowance.
- The trustees will pay tax at the RAT, (45% or 39.35%)
- If this is more than the settlor's liability, the settlor will get a refund but this must be repaid to the trustees

If income is paid to another beneficiary this will be paid with a 45% tax credit but whilst no additional is payable, no refund can be given.

Any CGT payable is still assessed on the trustees rather than the settlor.

Minor unmarried children

Whilst children have a personal allowance from birth if interest or dividends came from capital gifted by parents it will be taxed as parental income if this is over £100. Income from a trust set up by the parent will fall under this rule.

> A father sets up a Discretionary trust and his two children as potential beneficiaries. The daughter is 24 and his son is 13. The trustees pay a gross income £5,000 to both.
> The trustees will pay this with a 45% tax credit so each will receive £2,750 and a tax credit of £2,250
>
> Provided the daughter is not an additional rate tax payer she can reclaim part of the tax credit.
>
> Although the son is a non-tax payer the income will be considered to be the father's.
>
> The father is a higher rate tax payer so can only reclaim 5% of the gross amount whereas the son could reclaim all the tax if it was classed as his income.

That concludes this part so you should now understand:

- The taxation of Investment Bonds held in a trust.
- The tax rules for a vulnerable person's trust.
- The tax rules for a settlor interested trust.

Further Reading

https://techzone.adviserzone.com/anon/public/iht-est-plan/Taxation-of-Bonds-in-Trust

https://www.gov.uk/trusts-taxes/trusts-for-vulnerable-people

https://www.boltburdon.co.uk/yourlife/wealth-planning/settlor-interested-trust/

https://www.cii.co.uk/knowledge/technical-articles/articles/settlor-interested-trusts/39638