Historically trusts have been used to ring-fence assets to benefit a specified pool of beneficiaries for both income and capital. The treatment for UK income tax, capital gains tax (“CGT”) and inheritance tax (“IHT”) purposes is complex and depends on a number of factors including:

- The domicile of the settlor at the time he adds funds to the trust and in some cases when income or capital distributions are made;
- The residence status of the trustees;
- The residence status of the beneficiaries;
- Whether the trust assets are within the relevant property regime;
- If the trust is settlor-interested or can benefit the settlor’s minor child; and
- If the trust’s assets qualify as business property or excluded property for inheritance tax purposes.

The following provides an overview of a number of tax issues relevant for trusts.

**Interest in possession trusts**
(Trusts where the beneficiary has an absolute right to a specified share of the trust income)

An income tax liability does not arise on the trustees if all income is received after the deduction of UK tax. However, foreign income and untaxed UK income can cause a tax liability to be due. The trustees need to provide beneficiaries with a form R185 stating their entitlement to the trust income unless the income is directly mandated to the beneficiaries.

The beneficiary will be required to disclose this income if he submits a self-assessment tax return or pays higher rate tax. Certain capital receipts are deemed income for tax purposes such as offshore income gains and accrued income. These are liable at the additional trust rate (currently 45%) and do not form part of the beneficiary’s income entitlement so are not included on form R185. Chargeable event gains on non-qualifying policies held in trust are often taxed on the settlor (if still living and UK resident). If the settlor is not personally taxed on the chargeable event gain, a liability arises on the UK resident trustees at the additional trust rate.

Capital gains are assessed on the trustees. The 2016 Finance Bill (No2) provides a capital gains tax rate of 28% for residential property and 20% for other chargeable assets on gains realised from 6 April 2016. A trust is entitled to a capital gains tax exemption equal to half that of an individual’s exemption. However, this exemption is shared between the number of trusts created by the settlor (including life policy trusts but not charitable trusts and excluded property trusts) subject to a minimum of one fifth of the trust annual exemption. Trusts set up for qualifying vulnerable beneficiaries receive the same capital gains tax exemption as individuals.

**Discretionary trusts**
(Trusts where the trustees have discretion over how much of the trust income is distributed to the beneficiaries)

Trust income is subject to the additional trust rate (45% for non-dividend income and, from 6 April 2016, 38.1% for dividend income) but a basic rate band of £1,000 is available and income up to that limit is not liable to the additional trust rate. The basic rate band is shared between all trusts set up by the same settlor subject to a minimum of £200. Income distributions made to beneficiaries must be franked by an additional rate tax credit (45%). Beneficiaries can reclaim all or part of the tax if they are not personally liable to tax at the highest tax rate. If the tax pool is not sufficient to vouch the income distributions made to the beneficiaries, an additional trust charge will arise to the trustees.

The capital gains tax treatment mirrors that for interest in possession trusts.

**Settlor-interested trusts**

Trusts are settlor-interested if the settlor or the spouse or civil partner are able to benefit. Generally, the settlor is taxed on the income as it arises. The gift with reservation of benefit legislation applies to the trust fund if the settlor can personally benefit causing it to remain in the settlor’s estate for IHT purposes. The trust is nevertheless still subject to IHT ten-year and exit charges. Capital gains are not attributable to settlers of UK resident trusts. The settlor-interest provisions for offshore trusts are far wider than for UK trusts and UK domiciled/resident settlers of offshore trusts are taxed on trust gains as they arise.

A settlor who is personally excluded from benefit but who settles a trust for his minor child can be taxable on the income as it arises. This would...
apply if the child holds an interest in possession and all income received by the child and sourced from funds provided by the parent is £100 (gross) or more for the tax year. A parent/settlor of a discretionary trust for a minor child is liable to income tax when the income is paid out to the minor child.

Inheritance tax charges
A lifetime transfer of assets into trust is an immediately chargeable event for IHT purposes, unless the trust is a bare trust or a trust set up for a qualifying vulnerable beneficiary. If the value of the transfer into trust exceeds the settlor’s available nil rate band, an IHT liability will arise at the lifetime rate (20%) on the excess. A trust that holds relevant property is liable to inheritance tax in respect of ten year anniversary and exit charges. Life interest trusts existing as at 22 March 2006 may not be within the relevant property regime in which case the trust assets will be treated as forming part of the life tenant’s IHT estate. Certain trusts set up on death may not enter the relevant property regime e.g. trusts qualifying as immediate post death interest (IPDI) trusts or trusts for bereaved minors. The assets of these trusts will be treated as forming part of the beneficiary’s IHT estate.

Deeds of variation
A trust set up by a deed of variation is treated as settled by the deceased for CGT and IHT purposes (if the appropriate statements are made in the deed and the deed is made within two years of death). But for income tax purposes, the original beneficiary of the deceased’s estate who has implemented the deed of variation is treated as the settlor. If that individual is able to benefit from the new trust, it is a settlor-interested trust for tax purposes.

Hold-over relief
Capital gains can be held over in respect of transfers of assets to a relevant property trust (or if the asset is a qualifying business asset). But a hold-over claim cannot be made if the trust is settlor-interested or the trust benefits the settlor’s minor child. Also, hold-over relief cannot be claimed if the transfer is to a non-UK resident trust unless the transfer is of UK residential property. If the trust is later migrated offshore, a capital gains tax exit charge arises taking into account the increase in value of the trust’s assets at that time. If the settlor transfers residential property into a trust and claims hold-over relief, the main residence capital gains tax exemption cannot subsequently be claimed if a beneficiary of the trust uses the property as their main residence.

Hold-over relief can also be claimed on the release of trust assets to a beneficiary if the exit is a chargeable transfer for IHT purposes or the asset is a qualifying business asset.

Offshore trusts
These are most popular with non-domiciled individuals although UK domiciliaries also used them before tax legislative changes in 1998. Offshore trusts have a mass of anti-avoidance legislation and the tax implications are extremely complex. Specific advice should be sought if an offshore trust is applicable and there is any doubt regarding the UK tax implications.

Income or capital distribution?
Whether the distribution to the beneficiary is of income or capital can be difficult to determine. Trust income may be accumulated or ‘capitalised’ which can change its nature. From 6 April 2014, retained income that has not been formally accumulated will be treated as capital for the purposes of IHT if the income arose more than five years earlier. Trusts with retained but unaccumulated income should consider whether to formally accumulate the income before the next 10 year anniversary charge which may reduce the IHT charge arising. Establishing whether a distribution is of income or capital is dependent on a number of factors including the trust deed, how the income has been used by the trustees and whether the payment to the beneficiary has the nature of ‘income’.

Setting up a trust
A trust can be a very good solution for generation planning or if there is a number of individuals that the settlor would like to benefit in flexible terms from the trust assets. Planning should take into account the assets to be transferred, what type of trust to use, who should benefit and the tax implications and costs of administering the trust.

Breaking the trust
Due to the complexities of the trust legislation and changes to the tax treatment of trusts in recent years, more settlors, trustees and beneficiaries are asking whether their trusts should be broken. It is essential that reference is made to the trust deed and a full review of the tax, CGT and IHT position is made taking into account all factors before proceeding. In addition, if the trust or any beneficiary is resident or domiciled outside of the UK, the tax position of other relevant jurisdictions should be checked.

Contact us
Our consultants have experience in providing UK tax advice for both UK and offshore trusts and can discuss planning and compliance services with you. Please contact:

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