Crowe

Trust in Trusts

The tax implications of Trusts

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What is a Trust, and why would you have one?

A Trust is a legal arrangement between a ‘Settlor’ and ‘Trustees’. Trustees hold certain assets which previously belonged to the Settlor and use those assets to benefit one or more of the ‘Beneficiaries’.

The details of the arrangement are contained in a legal ‘Trust deed’ document which names the people involved and sets out the terms of the Trust. Trusts may be established while the Settlor is alive but can also be created through a Will.

There are a number of reasons to set up a Trust. It can provide flexible, financial protection for those important to you, making sure that value passes to the people you want it to. It can also benefit future generations in a tax efficient way.

Tax benefits of a Trust

Trusts are still a useful vehicle for protecting value for the family.

Capital Gains Tax

The gift of an asset to a family member which has significantly increased in value may result in a Capital Gains Tax (CGT) charge on the person making the gift.

However, if using a Trust, these charges can be deferred in a tax efficient way.

Inheritance Tax

Under existing legislation, it is possible for a husband and wife to put two times the nil rate Inheritance Tax (IHT) band (currently £650,000 in total) of value into a Trust every seven years without immediate IHT costs. With that amount and any growth on that amount not subject to IHT in the donor's estate after the seven years have elapsed.

The amounts that can be transferred into Trust can be larger where certain business or agricultural reliefs apply, or where the person making the gift has surplus income. As long as the person making the gift survives for seven years after the gift is made, the value of the asset will not be included in their estate for IHT purposes. If they do not survive the period, exemptions may still apply, and increases in the asset value following the gift should continue to be protected from charge.

Income Tax

It is possible to share income arising from assets held by the Trust across the wider family, making use of their personal allowances and lower bands of income tax, without the Trustees losing control of the underlying assets held in the Trust.

Example

Grandparents set up a Trust for their grandchild.

They contribute £312,500 cash into the Trust and it is invested into a property producing rental income of £12,500 a year (a 4% return).

The Trust would pay tax of:

£12,500 at a rate of 45% = £5,625

The Trustees (the grandparents) agree to make a distribution of income of £6,250 to the grandchild to help pay school fees for the grandchild.

The Trust is treated as paying out £6,250 net of 45% tax:

Gross distribution = £11,364

Refundable tax credit at 45% = £5,114

Net distribution = £6,250

Assuming the grandchild has no other income, the tax on the grandchild is nil, based on the distribution of £11,364, as it is less than the personal allowance.

In addition, the grandchild is entitled to an income tax repayment of £5,114. In total, the grandchild will receive £11,364.

The Settlor

The Settlor is the person who has put money or assets into the Trust. Assets are normally put into the Trust when it is set up and can be added to during the lifetime of the Trust.

The Trustees

Commonly, Trustees are the Settlor and trusted family members or friends of the Settlor, but they can also be professionals such as solicitors or accountants to ensure all decisions are made in the best interests of the Beneficiaries.

A Trust can have a maximum of four Trustees and generally require a minimum of two. Normally, the Trustees will act unanimously.

Trustees are the legal owners of the Trust assets. Their role is to:

- deal with the assets according to the Settlor's wishes, as set out in the Trust deed, or Will or letter of wishes
- manage the Trust on a day-to-day basis and pay any tax due
- decide how to invest or use the Trust's assets.

The Beneficiaries

A Beneficiary is anyone who benefits from the assets held in the Trust.

The beneficiaries are defined in the Trust deed and can be named individuals or classes of beneficiaries, such as my children and grandchildren.

Each Beneficiary may benefit from the Trust in a different way. For example, a Beneficiary may benefit from the income or the capital, or both. In some cases, the Settlor (or the Settlor's spouse) may also be a Beneficiary of the Trust. These are known as 'Settlor Interested Trusts'. However, this may be less effective for IHT purposes.

Types of Trust

There are several different types of Trust and they each have their own tax implications. The most common types are Bare Trusts, Discretionary Trusts and Interest in Possession Trusts.

Bare Trusts

A Bare Trust gives the Beneficiary an immediate and absolute right to both the capital and the income.

Although the assets are held in the name of a Trustee, they have no discretion over what income to pay the Beneficiary. Essentially, the Trustee is a nominee in whose name the assets are held, with no active duties to perform.

Discretionary Trust

The most common type of Trust is a Discretionary Trust. This type of Trust provides the widest powers and flexibility to the Trustees.

Trustees generally have 'discretion' about how to use the income and the capital of the Trust.

They can decide how much is paid to each Beneficiary, if any, and how often the payments are made.

Discretionary Trusts allow Trustees to take account of changes in circumstances, which the Settlor could not reasonably have foreseen.

Depending on the terms of the Trust deed, the Trustees may be allowed to accumulate income within the Trust for as long as the law allows, rather than pass it to the Beneficiaries. Income that has been accumulated becomes part of the capital of the Trust.

The Settlor can exert some measure of influence over the actions of the Trustees through a 'letter of wishes' which contains the current wishes of the Settlor concerning the Trust administration. For example, it may specify which Beneficiaries should be financially supported first or the nature of any investments made by the Trustees. However, this is not legally binding.

Interest in Possession Trusts

This Trust exists when a Beneficiary has a current legal right to any income from the Trust as it arises. Often these Trusts are set up in a Will, to benefit a surviving spouse.

The Trustees must pass all of the income received, less any Trustees' expenses and tax, to the Beneficiary.

The capital will usually pass to a different Beneficiary, or Beneficiaries, at a specific time in the future or after a specific event.

This type of Trust is also commonly seen during lifetime where control over the voting rights of company shares is preferred to be maintained, but the dividends on those shares are desired to pass to the next generation, without the cash flow implications of a discretionary Trust.

Immediate Post-Death Interest

An Immediate Post-Death Interest (IPDI) is a variation on an Interest in Possession Trust created in a Will effective post-death usually for the benefit of the surviving spouse.

This Trust is effective where couples are concerned about protecting assets for their children. This could be in cases of remarriage, where there are children from an earlier relationship or where there are concerns over the ability of the surviving spouse to handle the assets.

The surviving spouse is able to benefit from the income arising from the assets allowing them to enjoy the same standard of living during their lifetime, without access to the capital of the Trust fund.

The capital is protected for the Residuary Beneficiaries (usually the children) who will become entitled on the death of the second spouse.

The settlement of the assets on first death does not trigger a charge to IHT, due to the spousal exemption. This can also mean that the 'nil rate band' is preserved and therefore able to be passed to the surviving spouse. Although the assets then form part of the estate on second death, this is only for the purpose of calculating IHT. The Trust assets pass in accordance with the terms of the Trust, not the Will of the surviving spouse.

Other types of Trusts

There are also more unusual types of Trusts, including Trusts for disabled persons and for bereaved minors. We can provide you with specific advice on these Trusts where required.

Inheritance Tax

There are a number of circumstances in which IHT may become due for a Trust.

Setting up the Trust

If a Settlor transfers assets worth more than the 'nil rate band' (currently £325,000) into a Trust, and no exemptions apply, the excess above the limit can be charged immediately to IHT at 20%.

Ten-year anniversary

A Trust has a charge to IHT every 10 years on the anniversary of its creation. A 10-year anniversary charge will be applicable if the value of the Trust is in excess of the nil rate band available at the date of the charge.

The value of the Trust is calculated on the day before the 10-year charge and is the market value of any Trust assets less any debts and reliefs such as Business Relief or Agricultural Property Relief. It also includes the initial value of any other Trusts created by the Settlor on the same day. The rate of tax charged is capped at 6%.

Certain trusts, such as IPDIs, or Interest in Possession Trusts set up before 22 March 2006 are generally not subject to these ten-year anniversary charges.

Exit charges

IHT may be due when assets are transferred out of a Trust (known as 'exit charges') or when the Trust ends.

Income Tax

Trusts are subject to different rates of income tax depending on the type of Trust.

Low Income Trusts

From 6 April 2024, where a Trust receives income of £500 or less, it may be treated as a 'Low Income Trust'. The rules deem these trusts to have net income of £nil and therefore the Trustees may not be required to submit a self-assessment tax return to HMRC.

Where more than one trust created by the same Settlor exists in a tax year, the £500 limit is split equally amongst the trusts, subject to a minimum of £100 per trust.

Discretionary Trusts

Where a Discretionary Trust receives income over £500, the income will be taxable at the additional rate of tax being 39.35% for dividend income and 45% for savings and non-savings income.

When income is paid out to a Beneficiary, there is a 45% tax credit attached to it. If the Beneficiary only pays tax at the basic rate, they can claim a refund of any excess tax on their Self-Assessment tax return for the year.

Interest in Possession Trusts

Interest in Possession Trusts may also be treated as 'Low Income Trusts', where they receive income below £500, subject to the number of trusts in existence that were created by the same settlor.

Where an Interest in Possession Trust receives income over £500, the income is taxed at the basic rate of tax, i.e. 8.75% on dividend income and 20% on all other income.

The income is then taxable on the Beneficiary. If the Beneficiary pays tax at the higher rate, there will be additional tax to pay through their Self-Assessment tax return.

Sometimes the Trustees mandate income to the Beneficiary. This means it goes to them directly instead of being passed through the Trustees. If this happens, the Beneficiary will include this income directly on their Self-Assessment tax return.

Settlor-Interested Trusts

If a Trust is Settlor-Interested, then any income arising in the Trust is taxable on the Settlor, regardless of whether it has actually been paid out. The Trustees will provide details of the income received and any tax paid which will then be reported on the Settlor's tax return. As with Beneficiaries of an Interest in Possession Trust, if the Settlor pays tax at the higher rate, there will be additional tax to pay.

Any additional tax paid by the Settlor on trust income must be reimbursed by the Trustees. Any repayment of tax received by the Settlor which relates to the tax paid by the Trustees must be refunded to the Trustees by the Settlor.

Normally, Settlor-Interested Trusts are not effective for IHT purposes, as the value of the Trust is included in the Settlor's estate on their death.

Compliance

Most types of Trust will have both tax and anti-money laundering reporting obligations. These include the Trustees collecting and maintaining up to date information in respect of the Settlor, Trustees and beneficiaries; registering the Trust on the Trust Registration Service (TRS) with HMRC and submitting annual tax returns.

Some Trusts may have obligations to report on the Automatic Exchange of Information (AEOI) under Common Reporting Standards (CRS) or Foreign Account Tax Compliance Act (FATCA). Usually this only applies where there is a non-UK beneficiary receiving a benefit from the trust.

Start the conversation

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