Inheritance Tax and Trusts

Trusts have existed in one form or another since the Roman times, but the press coverage of trusts and their taxation in the last few years has often painted a rather bleak picture. A lot of this gloominess stems from a misunderstanding of the usefulness of trusts and how they are taxed these days. It is true that trusts are often not as tax efficient as they were in their glory days, but equally, they are perhaps not as cost-inefficient as might be made out.

The following aims to explain how UK resident trusts are taxed and to illustrate how it is not yet time to allow the dust settle on what can be a useful means of protecting family wealth.

**Lifetime Trusts - Inheritance Tax**

It might seem odd, but Inheritance tax (‘IHT’) applies to trusts in a special way which differs from normal IHT for deceased individuals. It comes about because once wealth is in trust, it is for the most part no longer counted in the estate of any individual (although there are some exceptions) and without special rules it could escape IHT forever. The idea therefore is that trusts are broadly taxed at the lifetime IHT rate (20%) once in a generation (or 30 years) in tranches of up to 6% max. every 10 years. There is also potential IHT exposure on the gifting of assets into trust, again at the 20% rate (and on death of the settlor within 7 years), and on the extraction of capital from a trust, at fractional rates depending on the passage of time.

**Transferring Assets into Trust**

On the transfer of an asset (be it cash, shares, property) into a trust, you may be immediately subject to a lifetime inheritance tax charge of 20% on part of the value of that transfer. However, this only applies to the extent that the value (plus the value of any similar transfers made in the last seven years) exceeds the settlor’s available “nil rate band”, which is currently £325,000. There are further reliefs where the assets transferred are assets used in a business, shares in unquoted trading companies, or agricultural assets, which reduce the taxable value possibly by up to 100%. If you survive for seven years after making a transfer, it will become fully excluded from your estate and fully fall out of account for IHT meaning no further inheritance tax is payable on your death in this respect.

**10-Year Charge**

With some exceptions, including certain trusts set up before 22 March 2006, most trusts will be potentially subject to an IHT charge on each ten-year anniversary of their establishment. The charge is levied at a maximum rate of only 6% of the value of the trust assets on the day before the anniversary, again only to
the extent that this value exceeds the current nil rate band. The calculation of this charge can get quite complex as certain transfers in the seven years prior to the trust being set up and any capital distributions from the trust in the intervening ten years need to be considered, but these all help to reduce the charge so are worth determining. Further injections of capital also have an effect.

**Exit Charge**
When capital assets (not income) are distributed out of the trust, a liability to an IHT “Exit Charge” may arise. Exit charges tax the distribution at a value equating to its proportionate “loss to the trust”, and take into account both the time that has passed since, and the effective rate of tax that applied (if any) at, commencement or the last 10-year anniversary. As such, the rate of tax applied on an ‘exit’ can be very small.

**Capital Gains Tax**
When non-cash assets are transferred into a trust, they are treated as if they had been sold at market value. This is the case with any gift. As a result a deemed capital gain can arise, even though no money has changed hands. However, if the assets transferred are qualifying business assets, or if in principle an immediate charge to inheritance tax arises (even if it is £0), this gain can be deferred (‘held-over’) against the value of the trust asset - UNLESS the transferor, their spouse, civil partner or minor children are beneficiaries, in which case this relief does not apply. The effect is that the trustees effectively take the asset on at its base cost to the settlor and so take on the gain to date which has yet to crystallise.

Any gains arising on assets sold by the Trustees will be taxed at 20% (28% for residential property) after deduction of the Trustees’ annual exemption (half of an individual’s allowance, but split with any other trusts settled by the same individual that are in existence in that tax year).

**Income Tax**
The income tax treatment of trust income depends on whether the trust is a “life interest trust” or a “discretionary trust”.

**Life Interest Trusts**
With a life interest trust (commonly referred to as an “Interest in Possession Trust”) the beneficiary is entitled to the use of the assets held in the trust, and thus to any income, net of the Trustees’ expenses (if any).

The Trustees of life interest trusts are taxed on income at the basic rate of 20% (7.5% for dividends) before passing the income to the ‘life tenant’. The life tenant can reclaim this if they do not pay tax, or will have no further tax to pay if they are basic-rate taxpayers. If however the life tenant is a higher or additional rate taxpayer they will have a further liability, after credit for the basic rate tax treated as paid by the Trustees.
If the income of the trust is mandated to the life tenant, it side-steps the trust and the Trustees will not pay tax at all. Instead the trust income is treated as arising directly to the life tenant.

Discretionary Trusts
The first £1,000 of income arising within discretionary trusts is taxable at 20% (7.5% for dividends) and thereafter at 45% (38.1% for dividends). When trust income is distributed to beneficiaries it is treated as paid net of a 45% tax credit. As such, if they are not additional rate taxpayers themselves, the beneficiaries can reclaim the “excess” tax over their marginal rate.

The trustees have to pay enough tax to cover the 45% credit and may therefore have an extra liability when a distribution is made if their actual liability does not already match this. Aside from the £1,000 standard rate band, this is most likely to happen due to the presence of dividend income.

Please note that where a trust benefits the settlor (i.e. the person settling funds into trust), or the settlor’s spouse or civil partner (and in some cases minor children), the income and gains arising within the trust are treated as arising directly to that settlor and not to the Trustees. This is known as a “Settlor-Interested” Trust.

Trusts created on Death (‘Will Trusts’)

Transferring Assets from the Estate into Trust
When assets are transferred into a Trust on death (a ‘Will Trust’), the Executors will need to first ensure that any IHT due has been paid on the assets being transferred, taking into account other assets, gifts made in the previous seven years and the available nil rate band(s) (currently up to either £325,000 or £650,000 on the second death of a married couple).

Where the Will creates a life interest trust, the treatment will be the same unless the intended life tenant is a surviving spouse or civil partner, in which case, no IHT will due because of the exemption on inheritances spouses and civil partners. Life interest trusts in Wills can be useful ways of ensuring your surviving spouse is provided with an income during life, but that the capital ultimately passes to your children or other beneficiaries.

A key difference between the discretionary trust and the life interest trust is that the assets of the discretionary trust are also outside of the estate of the beneficiaries, whereas the assets of a life interest trust created on a death are treated for IHT as belonging to the life tenant, so will be included within their estate on their death, and will not be subject to the 10-year charge and exit charges that discretionary trusts created in a Will may be liable for.
Exceptions
Certain types of trust such as those held for charities or those that are set up for vulnerable beneficiaries and bereaved minor children, are automatically granted more favourable tax treatment than described above, so long as certain conditions are met.

Conclusion
There is a saying that you should “never let the tail wag the dog” and the taxation of trusts is a perfect example of not letting tax solely determine your financial and personal decisions. A trust, if written correctly, provides huge flexibility for protecting the wealth of your family both in the present and the future. Trusts can provide opportunities to efficiently provide for the differing needs of different generations at once, as well as neatly dealing with the responsibilities of modern family arrangements from step-children and ex-spouses to civil partners and aging parents. Trusts can also shelter the future of family businesses from unwanted influences or less capable management. A trust remains, as it was always meant to be, a protection. Surely there can be nothing bleak about that?