

INHERITANCE TAX ON TRUSTS

Passing Assets to and from a Trust

The rules on the taxation of trusts changed significantly on 22nd March 2006. Prior to that date, it was possible to create certain types of trusts which carried considerable tax advantages. Trusts not qualifying for this special treatment were taxed in a much less favourable way. Most new trusts created since the change are taxed in the latter manner. There are still some types of trusts which have Inheritance tax advantages over others.

Prior to the 2006 change, trusts under which a beneficiary was entitled to the income of the trust assets and trusts under which the certain close relatives became entitled to the capital or at least the income by the age of 25 at the latest were treated as outright gifts. The result was that provided this type of trust was set up and the person setting it up and providing the assets survived for seven years, there would be no inheritance tax. Many such trusts still exist and are subject to the older, more favourable rules. No more can be created.

Since 22 March 2006, Inheritance tax applies upfront on the transfer of assets during a person's lifetime into a trusts. As set out in our general note on Inheritance tax, tax is charged on the date of transfer of the assets at half the normal rate (20%), once the persons "nil rate allowance of £314,000 is exceeded. If the person creating the trust dies within seven years, the higher death rate may apply but with credit for the tax already paid. Assets transferred to a trust on death by a will be taxed in the same way as all other assets in the estate, at the rate of 40%.

A further inheritance tax charge arise when assets are transferred out of the trust and there is a separate tax charge at ten year intervals on undistributed trust assets. These ongoing charges are avoided or minimised in certain forms of trust (see below).

Where trustees appoint assets or other benefits to a beneficiary, another type of Inheritance Tax, at a lower rate, will arise. The charge when assets leave a trust is based on the number of completed quarters since the creation of the trust or since the previous charge. There are forty quarters in a ten year period.

In the first ten years, Inheritance Tax is based on the settlement's average rate of tax. The settlement rate is 30% of this average rate. If, for example, the rate of tax on the settlement is 20% and the settlement rate is 30% of this namely, 6%. Inheritance Tax is charged on the full value of property distributed at rate of 1/40th of the settlement rate for each complete quarter between the setting up of the settlement and the event giving rise to the liability. There will be no distribution charge if the assets are appointed out within three months after the creation of the trust or three months after any ten year anniversary. The resultant tax rate will, in the example, will be between 0% and 6%.

If, in the above instance, the rate originally applicable to the settlement was nil because it was less than the nil rate band of the person creating the trust, then the amount chargeable on appointments of distributions will be nil. The original settlement rate may be may be very, ranging anywhere between 0 and 20% depending on the extent to which the transfer to the trust benefited from the nil rate. Accordingly the settlement rate may be extremely small.

In addition to tax on actual distributions, there is a ten year anniversary charge on the undistributed property in most trusts. This is calculated in the same manner as above. It restarts the clock ticking on the number of quarters in respect of subsequent transfers.

Trusts Exempt from Anniversary and Exit Charges

Certain trusts are exempt from the above anniversary and exit taxes.

When an immediate post death interest (an IPDI) is granted (e.g. an entitlement to the income for life), the recipient of the interest in possession is treated as owner of the underlying assets, for inheritance tax purposes. Therefore the assets are not deemed to be in the trust so that the anniversary and exit charges don't arise. Unlike the pre- 22 March 2006 position, this treatment does not apply on the creation of a lifetime trust with an entitlement to the income, so that that transfer is now taxed up front at 20%.

There are other consequences of deeming the recipient to be owner of the underlying assets. On the ending of the IPDI, there is deemed to be a transfer of the underlying assets by the recipient to the third party becoming entitled. If the power is exercised in favour of other beneficiaries the ending of the IPDI is a transfer of value. If this is an absolute transfer and the former recipient does not die within seven years, Inheritance Tax may be payable.

Trusts for bereaved minors qualify for special Inheritance Tax reliefs. This kind of trust can be set up under a will of a parent or under a deed of variation of a will. A bereaved minor is one who has not yet reached the age of 18 and at least one of whose parents have died. The parent can include a step-parent. As long as the minor is living and under 18 the income and property must be applied for the benefit of the minor only.

Upon reaching the age of 18 the minor must become absolutely entitled to the assets. There is no charge to Inheritance Tax where the bereaved minor becomes absolute owner of the assets before the age of 18 or if the assets are applied for the maintenance of the bereaved minor or the bereaved minor dies before reaching 18. The minor is not deemed owner of the underlying assets.

So called "aged 18 to 25" trusts are similar to the above but the beneficiary must receive absolute ownership on or before 25th birthday. The same conditions apply. As long as the beneficiary is alive and under the age of 25 he must be entitled to all of the income.

Where this relief applies tax is calculated by reference to the number of quarters that have passed since the beneficiary attained 18. The rate is calculated by reference to the settlement rate. There is no ten year anniversary charge.

There are also privileged trusts for disabled persons.

Trust Tax

When trustees themselves dispose of assets they will be subject to capital gains tax in the normal way. When a beneficiary becomes absolutely entitled to trust property and there is a potential Capital Gains Tax liability arising on any increase in value of the assets since the trust was created or since the date of death, in the case of a will.

Where the person creating the trust retains any interest in it, the capital gains of the trust are deemed to be his capital gains. Trustees are entitled to an annual exemption of half the standard capital gains tax exemption.

Trustees must pay income tax on all income produced by the trust assets. Trustees commonly receive investment income in the form of savings, rent, dividends or other investments. Frequently these taxes will be subject to deduction at source, 10% in the case of dividends and 20% in the case of interest. This may satisfy the basic rate liability.

There are two main scenarios in the income tax position of trustees. Where the beneficiaries have a right to the income under the terms of the trust, the tax charged on the trustees is 22%. Where the beneficiaries have no right to the income the trustees must pay at the standard trust rate which is 40%.

The beneficiary may also have liability to tax on trust income received or applied for his benefit. Where the beneficiary has a right to an income it will receive the dividend and interest after the trustees have paid 22% tax. The beneficiary's tax rate will be 32.5% on dividends and 40% on interest. The trustees give the beneficiary a Tax Deduction Certificate. The beneficiary will get credit for the tax paid by the trustees.

Where the beneficiary has no right to receive the income the trustees may pay it or accumulate it. If they pay it out then they must provide the beneficiary with a deduction form. Income received by the beneficiaries is treated as received net of tax.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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