Trusted solution

Inheritance tax and trusts

01 July 2015

Naomi Wells explains the reasons behind setting up a trust and how to do so

Key Points

What is the issue?

The taxation of trusts is a complex area and is under review by HMRC. Under these circumstances, many people may be disinclined to use trusts for tax planning purposes

What does it mean for me?

Despite the issues about trusts, there are still situations in which they can be highly suited to a client's needs and effective from a tax perspective

What can I take away?

It is essential to have a basic understanding of the practicalities and tax implications of setting up a trust and an awareness of the types of circumstances in which they may be beneficial

A settlement, or trust, is an arrangement where an individual, the settlor, transfers property to trustees. The trustees then hold the property on behalf of beneficiaries who have been chosen by the settlor. Where permitted, or required by the terms of the trust, the trustees may distribute some or all of the trust property and/or income to the beneficiaries.

Historically, trusts have been set up for a range of practical reasons and have also been used as a method for removing property from the settlor's estate to minimise the inheritance tax (IHT) liability that will arise on his death.

Over the past 10 years, trusts have been appearing more often on HMRC's radar and some of the tax advantages once associated with them have been eliminated. After major legislative changes in 2006, more trusts were brought within the relevant property regime and became subject to 10-yearly principal charges and also exit charges when property left the arrangement. In the past year, the government has put forward a number of options for amending the IHT legislation, including some that targeted the use of pilot trusts as a tax planning mechanism. Although these measures were not introduced in the first FA 2015, it is expected that they will be included in a future finance bill.

Despite these changes, there are still situations in which trusts are a practical and tax-efficient solution to circumstances faced by clients.

Practicalities of setting up a trust

It is normal and strongly advisable for a written trust deed to be drawn up by a solicitor. This gives legal certainty over the validity of the trust and provides a framework for its management and the use of its funds. For the trust to be legally effective, the following must be clear and unambiguous:

- the settlor's *intention* to declare a trust;
- which property is to be the *subject matter* of the trust; and
- who the *objects,* or beneficiaries, of the trust are to be.

The trust deed should also contain provisions relating to matters such as:

- the appointment, removal, retirement and replacement of trustees;
- the duties of trustees;
- the powers of trustees, including any powers they may have to appoint new beneficiaries; and
- any specific requirements for the use of trust assets and income.

The trust will be formally constituted on the actual transfer of the property into the legal ownership of the trustees.

Trustees have an overriding fiduciary duty to act in the best interests of the beneficiaries. There are also other legal duties, including ensuring that trust assets are properly transferred into the trustees' names, investing trust property, keeping true and accurate accounts, and not to profit personally from the arrangement.

Additional duties can be set out in the trust deed. However, it is important to ensure that any further duties do not unduly restrict the trustees' power to take necessary actions. There may be changes in circumstances that were not envisaged by the settlor when the trust was set up, and the trustees need to have the freedom to respond to these.

It is possible for one or more professional trustees to be appointed, such as the client's accountant and/or lawyer. Professional trustees are entitled to receive reasonable remuneration for the services that they provide to the trust. A higher standard of care will be expected of professional trustees due to their particular skills and expertise.

A new trust must usually be registered with HMRC for income tax and capital gains tax purposes by 5 October of the tax year after the trust is set up. This is done by completing form 41G. No registration is required if the trust has no income or gains and is unlikely to generate any in the future.

The trustees will need to set up a bank account for the trust. Before opening the account, the bank will wish to see a copy of the trust deed and will need full details and identification documents for each trustee. Trust work is a regulated activity under the money laundering regulations and professional advisers involved in creating a trust will need to consider the location and source of the funds, as well as the identity of the trustees, in order to identify potential money laundering risks.

Tax position when setting up a trust

IHT calculation

With the exception of transfers to a disabled person's trust, or to a bare trust, all lifetime transfers of property into trusts are chargeable lifetime transfers for IHT purposes. The transfer is valued on the loss to donor principle, which calculates the value of the reduction in the donor's estate as a result of the transfer rather than the standalone value of the assets transferred – see ***Example 1***. Where available, reliefs and exemptions can be deducted, such as:

- business property relief, claimed for transfers of qualifying business property;
- agricultural property relief, claimed for transfers of qualifying agricultural property; and
- the £3,000 annual exemptions for the current year and the previous year, if not already used.

Example 1

Miss Jones owns 55% of the share capital of Smith Investments Ltd. On 2 November 2014, she transferred a 25% holding into a trust, leaving her with a 30% holding. At that date, a 55% holding was valued at £100,000, a 30% holding was valued at £35,000, and a 25% holding was valued at £25,000.

Value of holding before transfer (55%)	£100,000
Value of holding after transfer (30%)	£35,000
Value transferred – loss to donor	£65,000

Any part of the nil-rate band that has not been offset against gross chargeable transfers (GCTs) in the previous seven years can also be deducted.

If paid by the donor, tax is due at 20/80 of the chargeable amount or, if paid by the trustees, at 20% – see ***Example 2***.

Example 2

Miss Jones's only previous transfer was a GCT of £300,000 in June 2009.

Value transferred (see ***Example 1***)	£65,000	
Less: 2014/15 annual exemption	(£3,000)	
Less: 2013/14 annual exemption	(£3,000)	
Nil-rate band	£325,000	
Less: GCTs in previous 7 years	(£300,000)	
		(£25,000)
Chargeable transfer		£34,000
Tax payable by Miss Jones at 20/80	£8,500	
Gross chargeable transfer (£34,000 + £8,500)	£42,500	

Miss Jones must file her IHT100 by 30 November 2015. The £8,500 IHT due must be paid to HMRC by 31 May 2015.

Care must be taken to ensure that the settlor is not a beneficiary or potential beneficiary. The transfer would then be a gift with reservation of benefit and could be included in the settlor's estate on his death.

IHT administration

Form IHT100 must be filed with HMRC within 12 months of the end of the month of the transfer. If the transfer is between 1 April and 30 September, any tax due is payable by 30 April of the following year. If the transfer is between 1 October and 31 March, any tax due is payable within six months of the end of the month in which the transfer occurs.

Capital gains tax

Relief is available under TCGA 1992 s 260 for transfers subject to an immediate IHT charge. This relief, in effect, defers the gain until the trustees dispose of the asset.

Reasons for using trusts

Use of the nil-rate band

A principal tax advantage of using trusts is that an individual can set up multiple trusts, each of which can benefit from a full £325,000 nil-rate band. This would be the case if:

- the trusts are set up more than seven years apart, so that the available nil rate band is not reduced by any previous GCTs; or
- pilot trusts are created on different days with a nominal initial sum, but the main trust property is added to the separate ones on the same day. The government is planning to introduce legislation so that same-day additions are taken into account when calculating charges on trust property. Advisers should maintain an awareness of developments in this area, particularly considering the effect of any new legislation on existing trusts and clients’ wills.

Even taking into account the 10-yearly principal charges on the trust property, there are still circumstances when transferring property to a trust can be advantageous from a tax perspective. The 10-yearly charges arise at a maximum rate of 6%, which is much lower than the 40% IHT rate on the death estate, although the frequency of the charges must be considered when planning. The trust will also continue to benefit from the fact that any GCTs made by the settlor after the trust was set up are not taken into account when calculating the available nil-rate band at the date of the charge.

Trust set up by deed of variation

Where property is left to an individual who already has substantial assets, a deed of variation can be made in writing within two years of the death to divert the property to a trust. This will prevent the property being included in the estate of the original beneficiary. Depending on the life expectancy of the beneficiary, this could help to prevent two higher IHT charges arising in close succession.

It is important to note that this deed of variation will be ineffective for income tax purposes. So if the beneficiaries of the resulting trust include the original beneficiary or his spouse or both, any income arising will be taxed on him personally. The settlement anti-avoidance rules will apply in relation to gross income of £100 or more paid from the trust to minor children of the original beneficiary.

Trusts with favourable tax treatment

There are special provisions for some types of trusts which can make them more favourable from a tax perspective. These may be of use to clients whose specific circumstances enable them to meet the required conditions.

- *Disabled person's trusts (DPT)* (IHTA 1984 s 89–89C) are set up for the benefit of those with recognised mental disorders, or who receive attendance allowance or disability living allowance. There are some conditions that must be met on the use of trust funds. The transfer of property to a DPT is a potentially exempt transfer for IHT purposes and does not give rise to a lifetime IHT charge. A DPT is treated as a qualifying interest-in-possession trust and does not suffer the 10-yearly and exit charges. The trust property will be included in the disabled person's estate on his or her death.
- *Trusts for bereaved minors (TBM)* (IHTA 1984 s 71A–71C), can be set up in specific circumstances for the benefit of a person under 18, at least one of whose parents (or person with parental responsibility) has died. The minor must become absolutely entitled to the settled property and any income arising from it on turning 18. No IHT exit charge will arise when the property leaves the trust at this time.
- *18–25 trusts* (IHTA 1985 s 71D–71G). These trusts are similar to TBMs, except that the property may remain in the trust until the child is 25. In this case, a reduced exit charge will arise based on the number of complete quarters since the child turned 18.

Control of assets

A primary non tax-related reason for using trusts is to ensure greater control over assets or to secure them for a particular purpose. For some clients, these types of considerations can be so important that they will wish to place assets into a trust regardless of the tax consequences. For example:

- A parent or grandparent may place assets into a trust to support a child who is not responsible enough to have instant access to the funds.
- An individual may wish to give one person the right to income produced by the assets, but wish the assets themselves to eventually pass to another person. An interest-in-possession trust can be used to achieve this end.
- After a family breakdown, trusts may be used to ensure that only the original family members can benefit from the family assets. ***Example 3*** provides an example of how a trust can be a tax-efficient method of retaining assets within a family.

  Example 3

  Mr and Mrs Brown were the owner-managers of a trading company that they had operated together for a number of years. After their divorce and Mrs Brown's remarriage, they wanted to ensure that the company shares remained within the family and ultimately passed to their son.

  They were each advised by a solicitor to enter into an option agreement which would allow their son to purchase the shares for a nominal sum should the parents die or cease to work for the company. However, the grant of the option to a connected person would have given rise to a deemed disposal at market value for capital gains tax purposes and could have led to a substantial capital gain.

  An alternative and more tax-efficient solution would have been for each parent to transfer their shares into a trust, the beneficiaries of which were their son and his descendants. Business property relief of 100% would have been available for the transfer, so no IHT liability would have arisen. CGT relief would have been available under TCGA 1992 s 260 to defer any gain arising. Although the trust would have been within the relevant property regime, the availability of BPR would have prevented any IHT charges being payable.

  The creation of the trust could have been coupled with a share reorganisation to enable the parents to continue to take dividends from the company.

Conclusion

Although there are problems and pitfalls associated with the use of trusts for tax planning, there are still circumstances in which they can provide clients with a practical and tax-efficient solution.