UK200Group tax

talking tax

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TRUSTS AND HOW THEY ARE TAXED…

Trusts are used widely for estate planning purposes and it is worth knowing the tax rules that apply to them...

How is a trust created?

Every person who can hold and dispose of property, or an interest in property, can create a trust in respect of it. The person creating the trust is called the settlor. A trust is usually created by the settlor with a trust deed.

Does the settlor have to pay tax?

Assets transferred into trust during an individual's lifetime may result in a chargeable gain arising on that individual, with any capital gains tax (CGT) payable by 31 January after the tax year of transfer.

There are important CGT reliefs available, such as on the transfer of business assets or where a transfer is subject to an immediate inheritance tax (IHT) charge (which is the case for most transfers into trust), even if the IHT rate on that transfer is nil. Transfers of assets to trust on death will not result in a CGT charge, as on death all assets receive a tax-free uplift to the market value at this date.

If the value of the transfer (reduced for reliefs for agricultural or business property) exceeds the settlor's nil rate band for IHT purposes, either in a lifetime for a transfer to a trust within the relevant property regime, or on death, an IHT charge arises.

Where the value of the assets transferred to a trust during the settlor's lifetime exceeds the available nil rate band at that time, a charge of 20% of the excess will be incurred. This liability can either be paid by the settlor (in which case the amount must be grossed up to an effective 25% rate) or by the trustees.

Inheritance tax is generally payable at 40% on the excess of the so-called "nil rate band" (currently £325,000) on the value of assets owned by an individual at the date of their death.

Can settlors benefit from the assets?

Although it is possible to retain an interest in assets gifted into trust, normally by the settlor or his spouse/civil partner being capable of benefiting from the assets, this will affect the tax treatment of the trust. Such settlor-interested trusts are taxed in a slightly different way to other trusts. In such cases, the income realised by the trust will be treated as the settlor's own and taxed in accordance with their personal circumstances. Also, there is no relief from CGT on transferring assets into settlor-interested trusts.

Do trusts have to pay income tax?

Any income received by a trust will be subject to income tax.

Where it is an IIP trust, the income is that of the beneficiary, but the trustees have to account for the tax. The trustees account for the tax on this income at the basic rates applicable to that income (20% or 10% for dividends), taking into account any trust management expenses.

The first £1,000 received by a discretionary trust will be taxed at the basic rate of tax ie 10% or 20% depending on the type of income received. This 'basic rate' band will be allocated to income taxable at 20% first and then against income which is taxable at 10% (ie dividends). Any income received above £1,000 will be taxed at the rate of tax applicable to trusts which is currently 50% (42.5% for dividend income).

Do trusts have to pay capital gains tax?

Capital gains realised by a trust are currently charged to tax at a rate of 28%. A trust has an annual exemption (currently a maximum of £5,800).

A CGT charge may also arise when assets are appointed from trusts, however, where there is also an immediate charge to IHT; an election can usually be made to hold-over the gain and transfer the gain to the recipient so they are liable to CGT on a future disposal.

How are the IHT charges payable by trusts calculated?

Under the so called 'relevant property regime', many trusts will also be subject to IHT charges every ten years. The maximum rate of IHT that can apply at this time is 6%. If a trust ceases before the 'ten-year charge', an apportioned charge may be incurred.

IHT may also be due when assets are appointed from a trust, known as an 'exit charge'. In this case, the charge to IHT is based on:

- the value of the property leaving the trust
- the proportion of the period of ten years for which the assets have been held on trust since the last ten-year charge
- the rate of tax at the last ten-yearly charge, subject to any IHT reliefs available at the time.

Do beneficiaries have to pay tax on trust income?

As mentioned above, beneficiaries with an IIP are taxable on all of the income available to them. As the trustees have already accounted for tax at the basic rate, the beneficiaries receive the income with a tax credit. This means that they should only have an additional liability if they are a higher rate taxpayer.

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Where income payments are made from a discretionary trust to the beneficiaries, the payments are treated as having had tax deducted at a rate of 50%. Generally the beneficiary will receive a tax credit for the tax deemed to have been deducted and it may be possible to claim a tax refund.

Do trusts have to submit tax returns?

Yes, all active trusts need to complete an annual tax return. Such tax returns need to be submitted to HM Revenue & Customs before 31 October (for paper returns) or 31 January (for electronic returns) following the end of each tax year. Any tax due in relation to that return will be due on 31 January following the year end. Penalties may be due if returns are submitted late.

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UK200Group Tax Panel members are renowned for their depth of knowledge and can advise on all areas of taxation with special expertise and experience of multinationals, UK companies, privately-owned organisations, sole traders, family businesses, trusts, partnerships and private individuals. Straight forward general enquiries will be dealt with quickly and free of charge. More complex specific client enquiries may require a fee charge which will be discussed and agreed by both parties prior to any work being undertaken. Tax enquiries can be posted to www.uk200group.co.uk members' home page under Specialist Panels, Tax Panel Newsgroup. The Centre is alerted to all enquiries posted on the UK200Group web site.

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