

technical factsheet 137

Changes to the Taxation of Trusts

Action required by 5 April 2008

Finance Act 2006 Changes – transitional period

The Finance Act 2006 made substantial changes to the taxation of trusts, introducing a much harsher regime than we previously had. The effect is that many 'interest in possession' trusts, that have been treated as though the underlying assets were those of the life tenant, will now be treated as discretionary trusts for capital taxes purposes. The privileges previously enjoyed by accumulation and maintenance trusts will also disappear and these trusts will become part of the discretionary regime.

These changes do not affect charitable trusts or trusts for disabled persons.

There is a window of opportunity for trustees to arrange matters so as to minimise the damage; this began on 22 March 2006 and will end on 5 April 2008.

What must we do now?

It is necessary to consider the effect of the changes on any settlements for which you have responsibility. Any changes considered necessary should be in place by 5 April 2008.

Accumulation and maintenance trusts

There are four possible options for accumulation and maintenance trusts:

- Do nothing and let the trust enter the discretionary regime.
- Change the terms of the trust so that the beneficiaries become absolutely entitled to the capital on or before attaining the age of 18. The old regime will then continue to apply and there will be no Inheritance tax charge on attaining an absolute interest.
- Change the terms of the settlement (if appropriate) to ensure that capital vests at the age of 25 and any application of income or capital must be for the beneficiary of the presumptive share and no-one else. Then the assets underlying the share will not enter the special charging regime until the beneficiary is 18.
- Wind up the trust before 5 April 2008.

Life interest trusts

If there is an existing life interest trust, it will automatically enter the 'relevant property' regime, unless it is a trust for a disabled person, an immediate post death interest or a transitional serial interest.

If the value of the trust fund does not exceed the nil rate band, there is no need to take any action, unless a substantial capital gains is expected to increase the value. The value for this purpose is not discounted for agricultural or business property relief.

Otherwise, the implications of the additional charge should be considered and the distribution policy.

Will trusts

These are probably still Inheritance tax efficient where spouse/civil partner exemption is concerned, but should be reviewed for immediate post death interests, trusts for bereaved minors and age 18 to 25 trusts.

The old treatment of interest in possession trusts will continue to arise after 22 March 2006 only in the following circumstances:

- the interest arises under the terms of a will as an immediate post death interest; or
- the interest is a disabled person's interest; or
- a transitional serial interest, i.e. it replaces a life interest already in existence on 22 March 2006; or
- on the death of the original life tenant, another life interest arises under the terms of the trust.

Residence of trusts

There were previously different sets of rules for Capital Gains tax and Income tax; these have now been aligned.

From 6 April 2007

New rules

Where a trust is created by a settlor who is resident, ordinarily resident and domiciled in the UK, **all** the trustees must be non-resident if the trust is to be non-resident.

If the settlor is non-resident and non-domiciled in the UK, it is only necessary for there to be **one** non-resident trustee for the trust to be treated as non-resident for both Income tax and Capital Gains tax purposes.

If the settlor is resident but non-domiciled in the UK at the date of setting up or providing funds, **all** the trustees must be non-resident.

The place where administration is carried out will no longer be relevant for CGT purposes.

If trust property is transferred from one trust to another, the settlor's residence must be tested at the time the trust was set up and at the time of the transfer.

- e.g. Sharon transfers her share portfolio with £1 million into a discretionary trust. She pays Inheritance tax at the lifetime rate (20 per cent) on the excess over the nil rate band. She will also pay Capital Gains tax (up to 40 per cent) on the gains in the portfolio.

Inheritance tax changes

Example

On 22 March 2006, Gillian was entitled to an interest in possession, subject to which the trust fund was held on discretionary trusts for her children. On 5 April 2006, Jennie is born. On 5 April 2007, the trustees terminate Gillian's interest and appoint the fund in favour of Jennie for life. Gillian has made a PET and Jennie has a TSI.

Any such appointment during the transitional period will be a TSI, but after 5 April 2008 will result in a relevant property settlement.

IHT is not payable on the termination of a qualifying interest in possession if on that occasion it is exempt from charge.

Example

Property is settled on Lisa for life, remainder to charity. On termination of Lisa's interest whether inter vivos or on death, there would be no charge to IHT, as gifts to charities are exempt.

Income tax

Example:

The David Trust has the following income:

Income from property £ 1,000, tax at 22% £220, net income from property £780. Expenses are £130.

David, the life tenant, is chargeable to tax on income from property net of expenses £650 (£780 - £130). This will be grossed up at 22% i.e. £833 , with a tax credit of £183. If he is a basic rate taxpayer, he will have no further liability.

Charges imposed by Section 687 ICTA 1988

Example

The Massimo Trust, a discretionary trust, received a dividend of £1,800.

Dividend £ 1800 + Tax credit £200 = £2,000

Tax at 32.5% 650

Income after tax £1,350

They distribute £1,200 to the beneficiary, M.

M's income: Distribution £1200 + tax 40% (800) = £ 2,000

Tax payable by trust: £650

Less: tax credit £200

£450

Due under S687 £800

Additional tax due £350

Due 31 January after the year of assessment.

Taxation of Beneficiaries

Example:

The Glenn Trust has net income of £1,200, which comprises bank interest of £1,500 from which tax of £300 has been deducted at source. Trust administration expenses of £400 have been deducted. G, the life tenant, is therefore entitled to the net income, after expenses of £800. He is a higher rate tax payer and is assessable to income tax on $(£800 \times 100/80) = £1000 @ 40%$ i.e. £400 less credit for $(£1000 @ 20%) = £200$ deducted at source. His tax liability will therefore be £200.