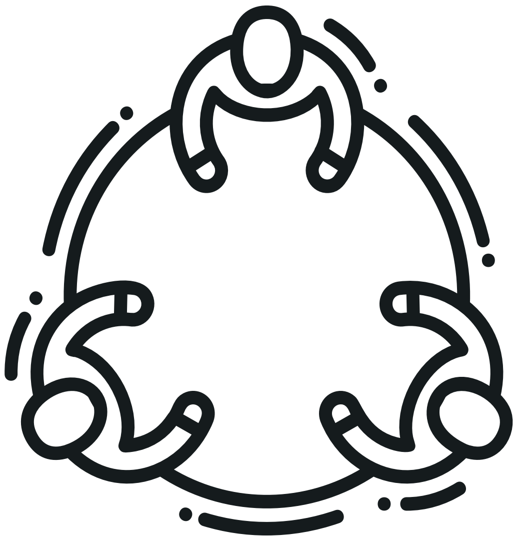
jack ross
chartered accountants



Trusts and tax planning

An introduction to the relationship between trusts and tax.

Trusts are a legal arrangement whereby assets are placed into the care of an individual who manages them for the benefit of someone else.

For the person placing the assets into the trust, they know that they are being properly looked after until they come under the legal control of the person who is intended to reap the rewards.

There are also tax advantages to setting assets aside in a trust.

A trust is a relationship between 3 parties:

- the **settlor** places the assets in the trust
- the **beneficiary** benefits from the assets in the trust
- the **trustee** manages the trust on behalf of the settlor and beneficiary.

By placing money, investments, land or property into a trust the settlor effectively relinquishes ownership over them.

Types of trusts

There are many different types of trust, including:

Bare trusts – assets placed in the trust are held in the name of a trustee, yet the beneficiary has the right to all trust capital and income when they turn 18 (or 16 in Scotland).

Interest in possession trusts – the beneficiary receives income generated by the trust but is not entitled to the underlying assets.

Discretionary trusts – the trustees have absolute power over how the trust assets are used and distributed.

Is a trust right for you? We can help you decide.

Income tax

The income that a trust generates may be subject to income tax as well as certain kinds of relief.

For accumulation, discretionary or interest in possession trusts some assets placed into a trust will be taxed as income, and are known as 'deemed income'.

Some examples of items deemed income are:

- gains made on life insurance policies
- lease premiums received instead of rent payments
- accrued income scheme profits.

Expenses

Trustees are likely to incur expenses as they go about their duty of managing the assets placed in the trust.

These are called trust management expenses and can be used to reduce the amount of tax payable by an interest in possession trust. They cannot be used in this way to reduce the tax paid by the trust for accumulation and discretionary trusts, but trustees can use the expenses suffered to reduce their own income tax liabilities.

Reliefs and allowances

In some situations a trustee will be able to reduce the tax liability of trust income coming from:

- foreign assets
- a trade or partnership carried on by the trustees
- land and property in the UK that is owned by the trust.

If the trust in question is set up for the benefit of vulnerable individuals, defined as having a disability or being under the age of 18, it may also qualify for special tax treatment.

Talk to our team about your income tax liability.

Capital gains tax

Capital gains tax (CGT) is paid on the profit (or 'gain') that is created by selling an asset for more than you bought it for.

CGT may need to be paid when:

- assets are put into or taken out of a trust
- a beneficiary gains access to the assets in the trust
- the trustee is no longer a resident in the UK.

There are, however, some instances when an asset can be moved but CGT is not liable.

Firstly, if a person dies and they leave their assets to the beneficiary there is no CGT liability. This may change if the asset is later sold at an increased value since the death in question. This is the case for both trustees and beneficiaries who inherit the asset through the terms of a will or intestacy.

Secondly, when an individual dies who is a beneficiary of an interest in possession trust and their right to an income from the trust comes to an end.

Allowable costs

Some expenses can be deducted when working out a trust's CGT liability. Examples of this kind of cost are those associated with improving a property to increase its value when sold or costs that occur during the sale or transfer itself (such as solicitor fees).

Allowable costs depend on the nature of the underlying asset.

Reliefs

There are several reliefs that could reduce the amount of CGT a trust might have to pay:

- **private residence relief** - no CGT is due when a main residence that the trust owns is sold
- **entrepreneurs' relief** - reduced CGT rate of 10% of qualifying gains when the trust sells assets used in the beneficiary's business that has now ended
- **hold-over relief** - trustees pay no tax if they transfer assets to beneficiaries (they will then pay tax if they sell them on later).

Tax-free allowance

For 2016/17 trustees only have to pay CGT if the total taxable gain is above £5,500 or £11,000 if the beneficiary is disabled.

Calculate CGT

There are 4 steps to working out your CGT liability:

- work out your gains and losses for assets sold or transferred
- deduct any allowable losses from total gains
- factor in any other losses
- deduct the trustees' tax-free allowance.

We can help you work out your CGT liability.

Inheritance tax

When calculating inheritance tax (IHT) liability, the difference between excluded and relevant property is important.

Most property held in trusts will be classed as relevant property and will therefore be included in IHT calculations. IHT may be due on assets held in a trust if:

- they are transferred out of a trust
- they have been in the trust for a decade.

There are numerous exceptions to this general rule so make sure to talk to an expert when working out whether assets have a potential IHT liability.

Transfers into a trust

For the majority of trusts, IHT at 20% will be due if transfers are more than the IHT threshold of £325,000.

If the person making the transfer dies within 7 years of making a transfer into a trust, the estate will have to pay additional IHT. The rate will depend on the length of time between transfer and death.

Transfers out of trust

Assets can be transferred out of a trust in certain situations, such as:

- the trust formally ending
- some assets being given to the beneficiary
- the beneficiary becoming legally entitled to use the asset.

There is an IHT exit charge applied to most transfers out of a trust. The maximum charge is 6%.

10-year anniversary

IHT is charged at every 10-year anniversary and is charged on the net value of the relevant property in the trust on the day before the anniversary. The way this charge is calculated is complex, so get in touch with us for more technical information.

If the beneficiary dies

The legal entitlement of the beneficiary to income generated by, or the assets held in, the trust differs depending on the type of trust and this will effect what happens if a beneficiary dies.

For a bare trust, because the beneficiary is entitled to both the income and assets of the trust, they become part of their estate when they die.

An interest in possession trust on the other hand differs because the beneficiary is only entitled to the income generated by the trust. There are certain circumstances where the value of this type of trust will be added to the deceased's estate.

For more information on trusts and IHT, get in touch today.

Cut through the complexity

This article has provided an introduction to trusts and taxation. Contact our expert team today for more specific guidance based on your situation and goals.

We can help you create an effective trust strategy.