

RELEVANT TO ACCA QUALIFICATION PAPER P6 (IRL)

Studying Paper P6?

Performance objectives 19 and 20 are relevant to this exam

THE TAXATION OF TRUSTS

This article is based on current tax legislation inclusive of the Finance Act 2009 and is relevant for candidates sitting the Paper P6 (IRL) exam from December 2010 onwards. The requirements of the Paper P6 (IRL) syllabus in respect of trusts are replicated below:

*A1(e)(i) Property and investment income from trusts and settlements:
Understand the income tax position of trust beneficiaries.*

A3(b)(vii) Capital gains tax: define settled property for CGT purposes, advise on the capital gains tax implications of transfers of property into and out of a trust.

A4(e) The capital acquisitions tax liabilities arising as a result of changes of interest in, and capital distributions from, trusts:

- i. Define a trust*
- ii. Distinguish between an interest in possession trust and a discretionary trust*
- iii. Advise on the capital acquisitions tax implications of transfers of property into trust*
- iv. Advise on the capital acquisitions tax implications of the termination of the life tenant's interest*
- v. Understand and apply the definition of a discretionary trust*
- vi. Advise on the advantages and disadvantages of using a discretionary trust*
- vii. Identify the occasions when a charge to capital acquisitions tax will arise in the case of a discretionary trust.*

The following aspects of the taxation of trusts are excluded from the syllabus:

- The computation of income tax payable by the trustee*
- The overseas aspects of trusts*
- The valuation of an annuity or interest in possession where the trust interest is the subject of an annuity.*

What is a trust?

A trust exists where a person (called the settlor), transfers the control of property to another person (called the trustees) to hold for the benefit of the beneficiaries. By settling property on a trust, the assets or the income from the assets can be used by persons other than the legal owner. The trust provides a structure whereby the assets of an estate can be transferred from one generation to the next where minor children

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are involved, or allows trustees to determine the needs and requirements of potential beneficiaries in the future through a discretionary trust.

While there are a number of different types of trusts, the main ones are:

- Fixed trust (also known as an interest in possession trust) – the trust document sets out who the beneficiaries are and how the income and capital of the trust is to be dealt with. Trustees do not have any discretionary power. This type of trust may be used to enable property to be held for persons who cannot themselves hold it, ie a minor child or incapacitated person, or to allow a life or limited interest to be given to a beneficiary.
- Discretionary trust – the potential beneficiaries are named in the trust document but do not have any right to the assets or income of the trust. The trustees have absolute discretion as to whom, and how much, if any, a beneficiary may receive. This allows the trustees to allocate the property of the trust to beneficiaries based on future needs and circumstance. In the case of a discretionary trust set up under a Will, the settlor normally provides a ‘letter of wishes’ indicating how they would like the property to be distributed which may influence the trustees.

The taxation of trusts

The trust is a separate taxable ‘person’ and the trustees are treated as a single and continuing body of persons, as distinct from the individual trustees. In considering the taxation of trusts, it is important to consider the potential tax implications on all participants, ie the settlor, the trustees and the beneficiaries. Exposure to taxation may arise under income tax, capital gains tax and capital acquisitions tax. Therefore, we will consider the various tax heads and how they may impact each party to the trust.

Income tax

Where the beneficiary is entitled, under the trust documents, to the income of the trust, this income is taxable on the beneficiary directly. However, where income is settled on a minor (under 18 and unmarried) and the settlor is alive, the settlor will continue to be assessed on the income arising to the trustees until the minor attains the age of 18. An exception arises where the trust is irrevocable, the income accumulates in the trust for the benefit of the child only and the trust cannot be terminated. In this case, the beneficiary, on reaching the age of 18, can reclaim any income tax paid by the trust and is taxed personally on this income.

Where income is generated by assets and held by the trustees, as in the case of a discretionary trust, the trustees are liable to income tax on this

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undistributed income at the standard rate, currently 20% (the calculation of this income tax is not examinable). Where a beneficiary subsequently receives this income from the trust, they are taxable under Schedule D, Case IV on this income and are entitled to a credit for income tax paid by the trustees.

Where income is accumulated in such a trust and is not distributed within 18 months from the end of the year of assessment, a surcharge arises of 20% of the gross income of the trust.

Capital gains tax (CGT)

The exposure to CGT must be considered in the context of the settlor on appointments to the trust and on the trustees on appointments to the beneficiaries.

The settlor

The transfer of property to the trustees is treated as a disposal by the settlor at market value for CGT purposes and the normal computational rules apply. Where the transfer arises on the death of the settlor, no CGT arises.

It should be remembered that the trustees of a trust, the settlor and anyone connected to the settlor are connected persons for the purposes of CGT and therefore, any capital loss arising on transfers of assets to the trust are ring-fenced against gains made on the disposal of other assets by the settlor to the trust.

The beneficiary

The beneficiary receives the benefit at market value.

The trustees

The trustees may be liable to CGT on appointment of benefits to the beneficiaries depending on the circumstances as outlined below:

Where the trustees appoint property to a beneficiary so that the beneficiary becomes 'absolutely entitled to the property as against the trustees', the beneficiary is deemed to take the benefit at market value. If the capital value of the trust assets had increased during the period that they were held by the trust, CGT will apply to the trustees and no annual allowance will be available.

Once the assets have been appointed absolutely on the beneficiaries, they are now considered settled and the trust is effectively finished. The trustees may continue to hold the asset as a nominee of the beneficiary and are then called 'bare-trustees'. However, any further disposals or transfer of this property is now done by or on behalf of the beneficiary.

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Example 1

Under the terms of a trust, the trustees hold property in trust for Michael until he reaches the age of 25. On attaining the age of 25, Michael will take an absolute interest in the property as against the trustees. A deemed disposal will arise on the trustees at market value and any resultant CGT will be payable by the trust.

Where a life interest in the assets of a trust terminates but the property remains in the trust, ie the beneficiary does not have an absolute interest in the property, then CGT may apply to the trustees (Example 2(a)). Where the life interest terminates on death and the trust assets pass to the beneficiary absolutely, then no CGT arises on the trustees and the assets pass at market value (Example 2(b)).

Example 2

(a) Gerald settled property on trust for his brother, Walter, for his lifetime; then on his son, Martin for his lifetime, and thereafter on Martin's children absolutely. On Walter's death, CGT arises on the trustees on the increase in market value of the property.

(b) Mary settled property on trust for her husband, Tom for his life and thereafter to her children absolutely. On Tom's death, the property transfers to the children at market value and the trustees have no CGT exposure.

Capital acquisitions tax (CAT)

No CAT arises on the transfer of property by the settlor to the trust as no one is beneficially entitled to the assets at that time.

CAT arises where a beneficiary becomes beneficially entitled in possession to property whether the interest is a life interest, an interest for a certain period of time, or an absolute interest. Where a taxable benefit is taken from a trust, the benefit is deemed to be taken from the settlor of the trust and the tax free thresholds and entitlement to reliefs are determined accordingly. For example, where Tom settles property on trust for the benefit of his daughter, Anna, during her lifetime and to her children absolutely thereafter, Tom is deemed to be the disponer and Anna is entitled to the parent-child tax free threshold in calculating the tax on her life interest. The future interest from Tom to Anna's children will not be taxed until it becomes an interest in possession on her death.

It should be noted that where a benefit consists of the income from an asset, this income may be liable to CAT in addition to income tax. It is

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understood that Revenue practice is not to seek to collect the CAT arising on the same event.

It is important to consider the territorial rules for CAT purposes as they differ between fixed trusts and discretionary trusts. In the case of a fixed trust, the normal CGT territorial rules apply, ie the benefit is taxable where either the beneficiary or the disponer are resident or ordinarily resident in the State at the date of the gift/inheritance. Special territorial rules apply to discretionary trusts and are set out in Table 1:

Table 1

Gifts taken under a Discretionary Trust created on/after 1 December 1999 (discretionary trusts created prior to this date will not be examined) are taxable if the settlor is resident or ordinarily resident in the State at:

- *the date of the disposition or*
- *the date of the gift or*
- *at the date of his death, if he has died prior to the gift being taken or*
- *the beneficiary was resident or ordinarily resident at the date of the gift.*

In any other case, only the Irish property is taxable.

Inheritances are taxable where the settlor is resident or ordinarily resident in the State at the date of the disposition, or the successor is resident or ordinarily resident in the State at the date of the inheritance, or the property was situated in Ireland.

Discretionary trust tax

Discretionary trusts attract two additional taxes which are designed to dissuade trustees from leaving assets un-distributed in trusts indefinitely thereby avoiding CAT.

1. A one-off discretionary trust tax charge of 6% arises where:
 - (i) the settlor is deceased, and
 - (ii) none of the principle objects of the trust (the settlor's spouse, children or minor child of a pre-deceased child) are under the age of 21 years.

A refund of 3% of this tax can be claimed where the assets of the trust are distributed within five years of the charge arising.

2. An annual 1% charge on the market value of property in a discretionary trust on 31 December each year. This 1% charge will not arise in the same 12 month period as the 6% once-off charge.

Example 3

John dies on 1 March 1999 and under the terms of his Will left his entire estate on discretionary trust for his sons Cormac and Jack. Cormac was aged 16 and Jack was aged 18 on 1 March 1999. The trust

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deed appointed the trust assets equally absolutely to each son on 1 March 2009.

The CAT position will be:

- No CAT arises on the assets going into settlement on the death of John as no person becomes 'entitled in possession' to any benefit.
- Discretionary trust one-off levy of 6% will not apply until Cormac, being the youngest principle object of the trust, attains 21 years of age.
- On 31 December annually thereafter the 1% levy is assessed and payable on the market value of the trust assets. Remember that this 1% is not payable within 12 months of paying the 6% levy.
- When Cormac and Jack become beneficially entitled to the assets on 1 March 2009. CAT arises on the market value of the benefits taken by each son from their father, John.

Remember also that agricultural relief and business relief will apply to gifts or inheritances taken from the discretionary trusts where the conditions are met, but will not apply to the 6% once-off charge nor the 1% annual charge.

Note also that the availability of a credit for CGT paid against CAT arising on the same event is also available in the case of trusts and is an important relief.

Conclusion

In determining the taxation treatment of trust transactions, it is important to consider the income and capital taxes that may apply to each of the settlor, the trustees and the beneficiaries. Keeping in mind that one of the main reasons for setting up a trust is to facilitate the manipulation of assets through the creation of life interests, limited interests etc, candidates should revise and be confident in their knowledge of the normal computational rules for CAT and be able to accurately compute the tax arising on benefits in these types of scenarios.

Written by a member of the Paper P6 examining team