RELEVANT TO ACCA QUALIFICATION PAPER P6 (UK)

Studying Paper P6
Performance objectives 19 and 20 are relevant to this exam

Trusts and tax

This article has been written because the taxation of trusts and the transfers of assets to and from trustees is a complicated area of the UK tax system. Accordingly, there is a need to set out the rules that may be examined and those areas where knowledge is not required. However, trusts represent only a small part of the Paper P6 syllabus and the existence of this article should not be seen as an indication that the taxation of trusts is of particular importance.

This article is based on tax legislation as it applies to the tax year 2010–11 (Finance Act 2010), and is relevant for candidates sitting the Paper P6 (UK) exam in June or December 2011.

Students sitting Paper P6 (UK) in 2012 will be examined on the Finance Act 2011, which is the legislation as it relates to the tax year 2011–12.

Accordingly, this article is not relevant to these students, who should instead refer to the Finance Act 2011 version which will be published on the ACCA website in 2012.

The requirements of the Paper P6 syllabus in respect of trusts include:
- the ability to define and distinguish between the different types of trust
- the ability to explain how income tax, capital gains tax, and inheritance tax apply to transactions involving trusts
- knowledge of the tax implications of creating a trust – now or in the future – including what will happen when trust property passes to the beneficiary
- knowledge of the inheritance tax implications of a settlor dying after creating a trust
- the ability to explain how trusts can be used in tax and financial planning.

The following aspects of the taxation of trusts are excluded from the syllabus:
- the calculation of income tax, capital gains tax, and inheritance tax payable by the trustees of a trust
- knowledge of situations where property is transferred between trusts or where the terms or nature of the trust is altered
- knowledge of situations where property within a trust with an immediate post-death interest passes to the spouse or civil partner of the settlor on the death of the life tenant
- knowledge of the special rules concerning trusts for the disabled, trusts for bereaved minors, transitional serial interest trusts, and age 18 to 25 trusts.

The Finance Act 2006 introduced fundamental changes to the inheritance tax regime surrounding trusts. These changes also affect the capital gains arising on transfers into and out of trusts, due to the availability of gifts hold-over relief, where a gift is immediately chargeable to inheritance tax.

WHY USE A TRUST?

The ability of trusts to solve problems stems from the fact that trusts enable the benefits arising out of owning property, for example the receipt of rental income in respect of a commercial investment property, to be enjoyed by someone other than the legal owner of the property. The law of trusts recognises that there can be a beneficial owner of property, known as the 'trust beneficiary', who is not the same as the legal owner (whose name is on the title deeds to the property), known as the trustee.

This split of legal and beneficial ownership gives rise to various possibilities including:

- the benefits of owning property can be transferred to minors whilst leaving control over the assets, together with the responsibilities of managing and maintaining them, with the trustees
- the income generated by assets can be made available to one group of individuals whilst the capital is preserved and protected for another individual or group
- provision can be made in a will for assets, or the income generated by them, to be directed towards those in financial need in the years following the death of the testator (the person who made the will)
- the creator of the trust can retain control over the assets.

In addition, a number of tax planning opportunities arise, including:

- assets may be transferred into trust such that they are removed from the settlor's estate (the settlor is the person who establishes the trust)
- assets may be transferred into trust such that they will increase in value outside of both the settlor's and the beneficiaries' estates
- trustees of a discretionary trust can direct income towards beneficiaries who are non-taxpayers such that there will be a repayment of the tax paid by the trust.

TYPES OF TRUST

A trust is created when a settlor transfers the legal ownership of property to the trustees who hold the property for the benefit of the beneficiaries.

Where a beneficiary is entitled under the trust deed to the income from the property or to use the property, the trust is an 'interest in possession trust' and the beneficiary is known as the 'life tenant'. The person who receives the trust property on the death of the life tenant is known as the 'remainderman' and their interest is known as a 'reversionary interest'.

This form of trust may be used in a will where there is a surviving spouse and children. The surviving spouse (life tenant) is entitled to the income generated by the assets but does not have access to the assets themselves. The children (remaindermen) will receive the assets on the death of the surviving spouse. Under this arrangement, if, for example, the spouse remarries, the capital is protected and will eventually be transferred to the children.

Where the trustees have discretion as to the accumulation and distribution of trust income and assets such that a particular beneficiary only has the possibility, rather than a right, of receiving a benefit under the trust, the trust is known as a ‘discretionary trust’.

This form of trust enables a settlor to make general provision for the future needs of the beneficiaries in a flexible manner. The trustees will decide how to meet the precise needs of the beneficiaries as and when they arise in the future.

Property can be transferred into trust by a settlor whilst they are alive or via their will. In addition, following an individual’s death, a trust can be created via a deed of variation.

TRUSTS AND TAX

When thinking about trusts and tax it is helpful to regard the trust, or the body of trustees, as a separate taxable person. Once this point is recognised it becomes reasonably clear that, for example, the trustees will pay income tax on the income generated by the trust assets. Beneficiaries receiving income from a trust are then entitled to a tax credit in respect of the tax paid by the trustees. (Note that the calculation of the income tax liability of trustees is not examinable.)

The transfer of assets to a trust, just like any other transfer of assets, brings to mind capital gains tax and inheritance tax. Both taxes must, of course, be considered again where property passes absolutely from the trustees to a beneficiary. In both situations it is important to apply the basic rules of the two taxes – the fact that the question concerns trusts should not be allowed to cloud the issue. (Note that the calculation of capital gains tax or inheritance tax payable by the trustees on the transfer of assets to a beneficiary is not examinable.)

Capital gains made by the trustees whilst they are managing the trust assets will give rise to capital gains tax. Trustees may also have to pay inheritance tax in respect of the property held within the trust. These payments are made every 10 years at a maximum of 6% of the value of the assets within the trust. (Again, note that the calculation of these tax liabilities of the trustees is not examinable.)

Inheritance tax

As far as inheritance tax is concerned, it is important to recognise when a trust was created and to know the relevant tax implications. It is then necessary to consider the inheritance tax valuation rules together with the availability of reliefs (particularly business property relief) and exemptions as well as chargeable transfers in the previous seven years.

Trusts created prior to 22 March 2006 are treated differently from those created on or after that date. It is not possible to ignore the old rules because they will have an impact on the inheritance tax due on subsequent gifts made by the settlor and on the death of the settlor or the life tenant in the future. Accordingly, there are two sets of rules to learn.

Trusts created prior to 22 March 2006 – 'Old trusts'

The inheritance tax implications of transferring assets to an old trust, and of property passing absolutely from such a trust to a beneficiary are summarised in **Table 1** on **page 7**. It can be seen from the table that:

- the lifetime creation of an 'interest in possession trust' or an 'accumulation and maintenance trust' (see following point) was a potentially exempt transfer whereas the creation of a discretionary trust was a chargeable lifetime transfer. This becomes relevant when calculating any further inheritance tax due on the death of the settlor.
- on the death of a life tenant of an 'old' interest in possession trust the trust property must be included in the deceased life tenant's death estate.

Note that **Table 1** refers to an 'accumulation and maintenance trust'. This was a particular type of discretionary trust, which had advantages for inheritance tax purposes. From 6 April 2008, such trusts become 'relevant property trusts' (see below and **Table 2** on **page 8**). The conditions that had to be satisfied for a trust to be an accumulation and maintenance trust are not examinable.

Trusts created on or after 22 March 2006 – 'New trusts'

The inheritance tax implications of transferring assets to a new trust, and of property passing absolutely from such a trust to a beneficiary are summarised in **Table 2** on **page 8**. It can be seen from the table that:

- the transfer of property to any new trust is a chargeable transfer.
- property comprised within an 'immediate post-death interest trust' (see following point) is regarded as belonging to the life tenant such that it will be included in the deceased life tenant's death estate.
- all other new trusts are known as 'relevant property (mainstream) trusts' and are subject to the 10-year charge and an exit charge when the property passes to the beneficiary. It should be noted that these charges are at a maximum of 6% (30% of the lifetime tax rate of 20%) which may not be significant in the context of the planning that is taking place.

Note that **Table 2** refers to a trust with an immediate post-death interest. This is a particular type of interest in possession trust, and is treated differently from all other 'new' trusts in that the trust property is treated as belonging to the life tenant for the purposes of inheritance tax. Such a trust can only be created on the death of the settlor.

Capital gains tax

As far as capital gains tax is concerned it should be remembered that there is no capital gains tax on death. Where the transfer to or from the trust has not arisen on death, it is necessary to consider whether the assets are chargeable or exempt. If they are chargeable, and a gain has arisen, the availability of reliefs, particularly gifts hold-over relief, should also be considered.

The capital gains tax implications of transferring assets to a trust, and of property passing absolutely from a trust to a beneficiary, are summarised in **Table 3** on **page 8**. These rules apply to transfers made on or after 22 March 2006. The rules that applied prior to that date are not examinable. **Table 3** shows that:

- there can be no chargeable gain on the creation of a trust with an immediate post-death interest as it can only be created on death.
- due to the availability of gifts hold-over relief, no capital gains tax need be paid on the transfer of **any** assets to or from a relevant property trust.

EXAMPLE 1
Alfred
Alfred is married with three children. His main assets are a valuable art collection and a number of investment properties. Alfred is writing his will and wants to provide for his wife, Molly, whilst ensuring that the capital value of his estate is preserved for his children.

Alfred could establish a trust with an immediate post-death interest via his will. Molly would be the life tenant and would have the right to use the trust assets and receive any income during her lifetime. On her death the assets would pass to the children.

Alfred would need to be advised that on the transfer of the assets to the trustees:
- there will be no capital gains tax as the trust will be created on his death.
- there will be no inheritance tax, as he will be regarded as having left his estate to Molly such that the spouse exemption will apply.

While the assets are in the trust:
- the trustees will be subject to income tax and capital gains tax on the income and gains arising in respect of the trust assets; Molly will also be taxed on the income but will receive a credit for the tax paid by the trustees
- there will be no 10-year charge.

On the death of Molly and the transfer of the assets to the children:
- there will be no capital gains tax on the gains made whilst the assets have been within the trust, because the assets are transferred as a consequence of a death
- the trust property will be included in Molly's death estate for the purposes of inheritance tax.

EXAMPLE 2
Carolyn and Eric
Carolyn and Eric are in their 30s and have been married for 10 years. They have two young children. They run a successful property investment company, Caric Ltd, which generates a significant amount of income and is rapidly increasing in value. They are looking for a way to reduce the value of their estates by transferring some of the shares in Caric Ltd to their children.

Where assets are increasing in value it is advisable to give them away sooner rather than later as the value for inheritance tax purposes is the value at the time of the gift. This is often not an issue with unquoted shares due to the availability of 100% business property relief. However, Caric Ltd is an investment company and, therefore, does not qualify for business property relief.

Carolyn and Eric will want to retain control over the shares in order to retain control over the future of the company. This can be achieved by transferring the shares to a trust and appointing themselves as trustees. The trust will then hold the shares for the benefit of the children.

The type of trust to use will depend on what they want to achieve. For example, they may need to use a discretionary trust if they wish to accumulate income or retain a degree of flexibility over its distribution. However, because the trust is not being created on death, the tax implications will be the same regardless of whether the trust is discretionary or subject to an interest in possession.

Carolyn and Eric would need to be advised that on the transfer of the shares to the trust:
- the transfer will be a chargeable lifetime transfer
- gifts hold-over relief will be available, even though Caric Ltd is an investment company, because the transfer is immediately chargeable to inheritance tax.

While the shares are in the trust:
- the trustees will be subject to income tax and capital gains tax on the income and gains arising in respect of the trust assets; a repayment of income tax paid may be available where income is distributed to non-taxpayers or those paying tax at the basic rate
- inheritance tax will be charged every 10 years on the value of the assets within the trust at a maximum of 6%.

On the transfer of assets to the beneficiaries:
- an exit charge will arise for the purposes of inheritance tax again at a maximum of 6%
- gifts hold-over relief will be available even though Caric Ltd is an investment company, because the transfer is immediately chargeable to inheritance tax.

CONCLUSION

Trusts can be used to solve practical problems where there is a desire to transfer wealth whilst protecting the capital or retaining a degree of control over the assets. They also represent a useful tax-planning tool.

When advising on the tax implications of using a trust you should consider all three relevant taxes, income tax, capital gains tax and inheritance tax, unless the question requirement states otherwise. Apply the fundamental rules of these taxes to the precise circumstances of the question in order to maximise the marks obtained.

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TABLE 1: INHERITANCE TAX AND TRUSTS CREATED PRIOR TO 22 MARCH 2006

	Transfer into trust	10-year charge?	Property passes absolutely to a beneficiary
'Interest in possession trust'	In settlor's lifetime: • potentially exempt transfer On death: • part of the deceased's estate	No	On the death of the life tenant: • part of the life tenant's estate On any other occasion: • transfer of value by the life tenant • no IHT if property passes to the life tenant • a potentially exempt transfer if it is to an individual • otherwise a chargeable lifetime transfer
'Accumulation and maintenance trust'	As for 'interest in possession trusts'	Yes	• trustees pay a maximum of 6%
'Discretionary trust'	In settlor's lifetime: • chargeable lifetime transfer On death: • part of the deceased's estate	Yes	• trustees pay a maximum of 6%

TABLE 2: INHERITANCE TAX AND TRUSTS CREATED ON OR AFTER 22 MARCH 2006

	Transfer into trust	10-year charge?	Property passes absolutely to a beneficiary
Trusts with an immediate post-death interest	Can only be created on death: • part of the deceased's estate	No	On the death of the life tenant: • part of the life tenant's estate On any other occasion: • transfer of value by the life tenant • no IHT if property passes to the life tenant • a potentially exempt transfer if property passes to any other individual • otherwise a chargeable lifetime transfer
Relevant property (mainstream) trusts (ie all other trusts)	In settlor's lifetime: • chargeable lifetime transfer On death: • part of the deceased's estate	Yes	• trustees pay a maximum of 6%

TABLE 3: CAPITAL GAINS TAX AND TRUSTS CREATED ON OR AFTER 22 MARCH 2006

	Transfer into trust on or after 22 March 2006	Property passes absolutely to a beneficiary
Trusts with an immediate post-death interest	Can only be created on death: • no CGT on death • trustees acquire assets at probate value	On the death of the life tenant: • no CGT on gains made whilst assets held by trustees On any other occasion: • compute gain by reference to market value • gifts hold-over relief is available in respect of qualifying business assets and on any assets if the transfer is immediately subject to IHT

Relevant property (mainstream) trusts (ie all other trusts)	In settlor's lifetime: • compute gain by reference to market value • gifts hold-over relief is available because the transfer is immediately subject to IHT On death: • no CGT on death • trustees acquire assets at probate value	• compute gain by reference to market value • gifts hold-over relief is available because the transfer is immediately subject to IHT