Taxation of trusts

Inheritance tax (IHT)

- **Trusts created in lifetime**

Transfers to most trusts during the lifetime of the transferor (the settlor) are immediately chargeable to IHT at lifetime rates, 20%. However, if their value, and that of similar transfers in the previous seven years is within the settlor's IHT nil-rate band, £325,000 (2020/21), there will be no IHT payable on the gift immediately, or in the future if the settlor survives for seven years.

During the lifetime of these trusts there is a potential charge to IHT every ten years on the value of the trust, plus the amount of any capital distributions made from the trust in the previous ten years. The rate of tax chargeable on ten-year anniversaries is however limited and is currently a maximum of 6% of the value over the then nil-rate band.

The rate worked out at a ten-year anniversary will apply to distributions from the trust in the following ten years, recalculated using the current nil-rate band and reduced proportionately to take account of the time that has passed since a previous ten year anniversary.

Once assets are in the trust, any capital growth and accumulations of income will be outside the IHT charge on the settlor's own estate immediately, unless the settlor is a potential beneficiary of the trust in which case all of the trust assets will still be treated as part of their estate for IHT purposes.

- **Trusts created by will**

Most trusts created under a will are chargeable to IHT in the deceased's estate to the extent that the value of the assets of the estate that pass to the trust and to other chargeable beneficiaries are in excess of the deceased's nil-rate band, including any transferable nil-rate band arising from the estate of a spouse or civil partner, up to £650,000 (2020/21). In some circumstances this could be increased to £1,000,000 if the residential nil rate bands of both spouses are available.

Assets that pass to a life interest trust under a will where the surviving spouse or civil partner is the beneficiary entitled to the trust income (the life tenant) however are exempt from IHT on inception but will be chargeable in the same way detailed above if the life tenant is someone else.

During the lifetime of life interest trusts created by will, the assets are treated as belonging to the life tenant, and if on their death they are still entitled to the trust income the value of the trust will be included in their estate for IHT purposes.

Discretionary trusts created by will are subject to the same regime of ten year and exit charges as lifetime trusts.

Capital gains tax (CGT)

CGT is payable on chargeable gains made in trusts at 20% after taking into account the trustees' annual exemption which is broadly half the personal exemption divided by the number of trusts set up by the settlor. Chargeable gains on residential property are taxed at 28%.

Transfers of assets to or from a lifetime trust constitute a disposal for CGT purposes. It is however possible to defer any notional gain arising until the asset is actually disposed of by the eventual transferee, except on the transfer of assets to a trust where the settlor is a potential beneficiary.

Income tax

The trustees of a life interest trust are responsible for tax to satisfy the basic rate tax liability on any income they receive before payment to the life tenant. As the life tenant of a Life Interest Trust is entitled to the income, they are responsible for any tax liability due on it to their own marginal rate of tax.

Income received within discretionary trusts above the standard rate band, £1,000, is subject to the special trust tax rate, 45% on non-dividend income and 38.1% on dividends if accumulated but 45% ignoring tax credits received if the dividends are distributed to beneficiaries. Income within the standard rate band is taxed at the rate to satisfy the basic rate tax liability.

If the income from a discretionary trust is distributed to a beneficiary, they may be able to claim repayment of some of the tax paid depending on their own personal taxation situation and provided that the settlor is not also a beneficiary.

Where the settlor is a beneficiary the trust income is assessable on them with credit for the tax paid by the trustees. Any tax repayment or benefit that the settlor receives personally as a result of the trust income must be repaid to the trust.

The trustees are responsible for making any relevant returns to the HM Revenue & Customs during a trust's existence and on its distribution. The Trust may also need to be registered with H M Revenue and Customs' Trust Registration Service.

Assets in a charitable trust are free of IHT, CGT and income tax. Certain trusts for disabled beneficiaries may be subject to a more beneficial tax regime.

For further information please get in touch with your usual Lodders contact or via:

Stratford upon Avon office – 01789 293259
Henley in Arden office – 01564 792261
Cheltenham office – 01242 228370