Introduction

A trust is a legal obligation that binds trustees to deal with property for the benefit of beneficiaries. It is a way of giving property to other people without allowing them full control over it. A large proportion of all private wealth in the UK is held in some form of trust.

Many trusts are set up by a will as a means of ensuring the desired succession to the deceased's assets. For example, a will might bequeath the income from assets to the deceased's widow and the assets themselves to the deceased's children on the widow's death. The children thereby inherit the assets regardless of the provisions of the widow's will, remarriage of the widow or the intestacy laws if the widow does not have a valid will.

A person may also put property into a trust during his or her lifetime. Lifetime trusts are often used as a means of reducing inheritance tax (IHT) while avoiding outright gifts in undesirable circumstances, such as where the beneficiaries are children or where the identities of all the eventual beneficiaries are not yet known. They have also been used to keep landed estates in the family and to protect family property from creditors or from spendthrift family members. Nowadays, almost all lifetime gifts of property into a trust are made in order to gain some form of tax advantage.

Trusts can also arise by operation of law or by implication. For example, a business partnership might buy property for the business, which is held by one or two of the partners for the benefit of the whole partnership. This is an implied trust. For tax purposes this is the same as if all the partners owned an equal share of the property.

Trusts also exist under intestacy and bankruptcy law, charities may be constituted as trusts and there are specialised trusts such as in pension schemes and employee share schemes. These types of trust generally have their own tax rules, which are not covered here.

This section covers the main tax rules that apply to trusts created by will, intestacy or by a gift into trust. Tax avoidance using trusts has become a major industry and almost every Finance Act contains new legislation designed to clamp down on some scheme or other. Certain types of tax avoidance schemes must by law be disclosed to HM Revenue & Customs (HMRC).

Much of this anti-avoidance legislation, some of which has a broader application than trusts created deliberately, is complex, especially where it concerns overseas trusts, and is only touched on briefly here.

The Finance Act 2006 radically changed the IHT treatment of many types of trust and made a number of changes to the income tax and capital gains tax (CGT) treatment. The pre-2006 rules remain relevant, however, as they still apply to most older trusts.

The legal background

Tax legislation covers the settlors, trustees and beneficiaries of a trust, and varies according to the type of trust involved.

Settlors, trustees and beneficiaries

Every trust has a settlor (or settlors), trustees and beneficiaries.

Settlors

A settlor is any person who contributes property to the trust. A settlor may give away property irrevocably or retain some interest. For example, the trust property may revert to the settlor if a beneficiary dies. Anti-avoidance legislation taxes settlors who retain an interest in the trust property.

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Scottish law does not use the term 'settlor': the Scottish equivalent of a settlor is a truster or granter.

Trustees

The trustees administer the trust property, which is held in their name. They are therefore the legal owners. Trust law imposes a number of duties upon the trustees.

The trustees are normally taxable on trust income and gains and responsible for completing tax returns and paying the tax due under self-assessment.

Beneficiaries

The beneficiaries are those persons for whose benefit the property is held. They are the beneficial owners.

Beneficiaries are normally liable to income tax only on trust income to which they are entitled. They are not normally liable to CGT on trust gains.

Beneficiaries' interests in trusts take a variety of forms.

- A life interest (life rent in Scotland) is a right to enjoy the income from, or use or occupy, all or part of the trust property during the lifetime of that beneficiary or of some other person.
- An interest in possession has an immediate right to trust income as it arises. The trustees have no power to withhold or accumulate income other than what is needed to pay tax and administrative expenses.
- An interest in possession is a life interest if it is defined by reference to a life. If it will come to an end when the beneficiary reaches a specified age, it is not a life interest.
- A discretionary interest in trust property is an interest that depends on the trustees' discretion.
- A beneficiary who will receive settled property after other beneficiaries' interests have come to an end holds a reversionary interest. For example, if Lisa is entitled to live in a house during her lifetime and on her death the house will pass absolutely to Joe, Joe has a reversionary interest.

Types of trust

The way tax impacts upon the parties involved in a trust depends on which of four types of trust it is.

Bare trusts

A bare trust exists where the trustees act as nominees for the beneficiary (or beneficiaries) who is absolutely entitled to the assets, or would be if aged at least 18. For most purposes this is not a true trust, and beneficiaries are taxed as if they owned the assets absolutely.

Bare trusts often arise by operation of law, for example, an individual holding title to property on behalf of others. Their most common intentional use is where the beneficiary is a minor.

Interest in possession trusts

An interest in possession trust exists where one or more beneficiaries has an interest in possession, i.e. a right to the income for the present time, whether or not a life interest.

Discretionary trust

A discretionary trust is one where the trustees have discretion over the distribution of trust income and capital.

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Accumulation and maintenance (A&M) trust

This was a special type of discretionary trust that had IHT advantages before the Finance Act 2006. It had to satisfy all the following conditions:

- One or more beneficiaries would become absolutely entitled to the property, or obtain an interest in possession in it, on attaining a specified age not exceeding 25.
- Until then the trustees had to accumulate the income or apply it for the maintenance, education or benefit of the beneficiaries. However, under the Perpetuities and Accumulations Act 1964, the maximum period for the accumulation of income is generally 21 years. So where beneficiaries are under the age of four when the trust is created, an interest in possession had to be granted earlier than age 25.
- The trust had to last no longer than 25 years or be for the benefit of grandchildren of a common grandparent.

From 22 March 2006, the Finance Act 2006 prevents the creation of any new A&M trust that would benefit from the favourable IHT treatment. In theory, the A&M trust structure can still be used — with no IHT benefits — but a discretionary trust, which offers greater flexibility, would generally make more sense now.

Creation of a trust

The deed will specify:

- The trust property.
- The names of the trustees.
- The beneficiaries, by name or within a defined class.
- The powers of the trustees and the rights of the beneficiaries.

The wording of the deed must be precise and capable of legal definition. It must be clear that a trust is intended.

Once a trust is created it cannot be changed or revoked by the settlor, trustees or beneficiaries, unless the trust wording specifically allows this. There are some limited exceptions.

A trust may be created orally but this is usually unwise. Where a trust is created during the settlor’s lifetime, it is best if a trust deed is drawn up by a suitably qualified lawyer otherwise the trust might not be valid or might not put into effect the settlor’s wishes.

Powers and duties of trustees

A trust usually has two to five trustees, except that a trust that includes land cannot have more than four trustees.

- Most trustees are individuals, but it is possible to appoint a trust corporation as a trustee. Banks often provide this service.
- Any individual who is 18 or over and sane may be appointed a trustee.

The job of the trustees is to hold the trust property and administer it for the benefit of the beneficiaries in accordance with the trust deed.

- They are the legal owners of the property and their names would appear on any documents.
- Trustees in England and Wales and Northern Ireland have a statutory duty of care. They must act in the way that an ordinary prudent businessperson could be expected to act,

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allowing for the particular skills and experience of the trustee in question. A similar common law duty applies in Scotland.

- Most trust deeds contain wide powers of investment. Where the deed has no specific investment powers, trustees are allowed to make the same types of investments as they could if they owned the property outright, subject to the duty of care and paying heed to standard and prudent investment criteria. The trustees must obtain and consider investment advice, which would normally mean using an external investment adviser unless the trustees have their own investment expertise.
- Trustees must keep proper accounts of all trust property, which the beneficiaries are entitled to see on demand.
- Professional trustees may charge for their services, but lay trustees cannot do so unless the trust wording specifically allows this.
- Trustees who do not act properly may be liable to pay compensation to beneficiaries for breach of trust. Trust deeds may include a clause exonerating trustees for a non-fraudulent accidental breach of trust.

Trustees of a discretionary trust have the power to decide how much of the trust's income is distributed and to which beneficiaries.

Some trusts give trustees a power to appoint or vary beneficiaries within a defined class of beneficiaries, for example, all direct descendants of the settlor.

Such flexible trusts can cater for changing circumstances. They are also useful in tax planning.

There may be a default beneficiary, but there are several tax disadvantages if this is the settlor.

Taxation of trusts

Income tax, CGT and IHT all have special rules for taxing trustees, settlors and beneficiaries. Some of the provisions vary according to the type of trust.

The residence of the trust — UK or overseas — is also relevant to some of the tax rules.

In this section the term 'discretionary trust' is used to mean a discretionary trust that is not an A&M trust.

Bare trusts are not taxed as trusts. Tax liabilities are the same as on an outright gift to the beneficiary.

Inheritance tax

IHT may affect the settlor, trustees and beneficiaries. The rules for interest in possession and A&M trusts changed significantly with effect from Budget Day in 2006 (22 March). The rules for discretionary trusts remained the same.

Trusts created after 21 March 2006 (and discretionary trusts created at any time)

The settlor

The creation of a trust is a 'transfer of value' under the IHT rules. The settlor is liable to IHT on the loss in value to their estate under the normal IHT rules (see the separate topic 'Key features of inheritance tax').

With one exception, tax is payable at 20% if, after any available exemptions, the transfer fell outside the settlor's nil-rate band. A transfer is wholly within the nil-rate band if it, plus any other

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transfers of value by the settlor within the previous seven years, does not exceed the nil-rate band (£325,000 for 2011/12 to 2014/15).

- Thus a transfer of £340,000 into a trust in 2011/12 where no exemptions were available would generate an immediate tax charge of £3,000 (i.e. 20% of £15,000) if paid by the trustees.
- If the tax is paid by the settlor the gift is grossed up and the tax becomes £3,750 (20% of £15,000/0.8). The gross gift is £18,750, which is the net gift of £15,000 plus the tax.
- There might be further tax if the settlor dies within the next five years.

If the chargeable lifetime transfer involves cash, quoted shares or securities, then unless the donor's total chargeable transfers in the past seven years (including the current transfer) exceed the nil-rate band, the transfer does not have to be reported to HMRC. For other assets, a transfer does not have to be reported if:

- The total chargeable lifetime transfers in the past seven years do not exceed 80% of the nil-rate band, and
- The value transferred by the current gift (ignoring reliefs and exemptions) does not exceed the nil-rate band available to the transferor at the time of the gift.

Different rules apply to gifts into a disabled trust:

- Such a gift is treated as a potentially exempt transfer (PET) at the time it is made. This means it is exempt at the time it is made and becomes liable to IHT only if the settlor dies within seven years of the gift.
- A disabled trust has to satisfy specific conditions.

After property has been transferred to a trust, it is outside the settlor's estate and therefore escapes IHT on the settlor's death, unless the settlor has retained an interest in the trust. However, if the settlor dies within five years of making a chargeable lifetime transfer there could be IHT at the death rate less the lifetime rate tax already paid.

The trustees

The trustees of most trusts are potentially liable to an IHT charge every ten years on the whole of the property in the trust at the time.

The amount of tax payable broadly depends on the value of the settlor's transfers immediately before the date of creation of the trust and the value of the trust property.

The maximum rate is 6%, but it is almost always much lower than this. Where the value of the trust property is not more than the IHT nil-rate band, the ten-year charge may be nil.

A discretionary trust may also be liable to an IHT exit charge whenever trust property (not income) is transferred to a beneficiary.

The calculation is complex and depends on similar factors to those that determine the ten-year charge.

The only new trusts that fully avoid these charges are:

- Trusts for 'bereaved minors' created on death by a parent or established under the Criminal Injuries Compensation Scheme for a minor child who will be fully entitled at age 18.
- 'Immediate Post Death Interest' interest in possession trusts created on death by will or intestacy.
- Trusts created either in the settlor's lifetime or on death for a disabled person.

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The beneficiaries

The beneficiaries are not liable to IHT while the property remains in the trust.

Interest in possession and A&M trusts created before 22 March 2006

The settlor

Before 22 March 2006 the creation, or transfer, of property to an interest in possession trust or to an A&M trust was a PET.

The trustees

Before 22 March 2006 the trustees of an interest in possession trust or an A&M trust were not subject to IHT on the trust property while it was in the trust or when it was distributed.

The beneficiaries

A beneficiary with an interest in possession was treated as owning the whole of the trust property for IHT purposes.

When the beneficiary dies, the value of the trust property is within the beneficiary's estate and liable to IHT if their estate exceeds the nil-rate band.

A&M trusts

A&M trusts that existed before 22 March 2006, and where the trust provides that the trust assets will go to a beneficiary absolutely at age 18, will not be liable to periodic or exit charges.

Where the trust passes the trust assets outright to a beneficiary between age 18 and 25, an exit charge will apply for the period beyond the beneficiary's 18th birthday, i.e. the maximum theoretical charge at age 25 is 6% × 7/10 = 4.2%.

Other A&M trusts have been subject to the discretionary trust regime since 6 April 2008. Ten-yearly anniversaries will depend on the original date of the trust, but for the first periodic charge after 5 April 2008 the charge will reflect the fact that it has not been subject to the new regime for the full ten years.

Interest in possession trusts

The previous rules for interest in possession trusts created before 22 March 2006 continue unless the interest current on that date is changed after 5 October 2008.

- If someone then takes absolute ownership, this is a transfer by the previous beneficiary as before.
- If when that interest comes to an end the trust continues, this is treated as a chargeable lifetime transfer by the outgoing beneficiary (if alive) or part of their estate (if on death). Thereafter the trust will be subject to the new regime with the exit and periodic charges.
- The previous rules continue where a new interest in possession arises in a pre-22 March trust on the death of a spouse or civil partner, regardless of when this occurs.

Life policies

Special rules apply to life policies placed in interest in possession trusts before 22 March 2006. In effect, these policy trusts are generally regarded as remaining subject to the previous tax regime, where new interests come into being as a result of the death of the previous holder of the interest after 5 October 2008. Premiums will generally continue to be treated as PETs.

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Overseas aspects

The country in which the trust is created has no effect on the IHT liability of the settlor, trustees or beneficiary.

- Property situated outside the UK and held in a trust escapes IHT if the settlor did not have a UK domicile at the time the property was transferred to the trust.
- In all other circumstances, any property placed into a trust by a UK-domiciled settlor is liable to IHT, wherever the property is located.

What is meant by 'domicile' is explained in the separate topic 'Residence and domicile and the taxation of overseas income'.

Income tax

In straightforward cases, the trustees are liable to income tax on trust income and beneficiaries are taxable when income is distributed to them.

However, settlors may also be taxable under anti-avoidance rules that prevent taxpayers avoiding income tax by placing assets in trusts or settling income on others under arrangements that are not a trust in the full sense.

Certain trusts for vulnerable beneficiaries may be taxed using the individual beneficiary's personal allowances, tax rates and rate bands rather than at the trust rate. This tax treatment, which also applies to CGT, is not available automatically – it must be claimed.

Vulnerable beneficiaries include orphaned minor children and people with disabilities.

Trustees

Trustees are normally liable to income tax on trust income if at least one trustee is resident in the UK.

There is an exception to this rule where there is at least one non-UK resident trustee and the settlor was not resident, not ordinarily resident and not domiciled in the UK at the time property was placed in the trust. In such cases the trustees are not liable to income tax.

See Topic 8, the separate topic 'Residence and domicile and the taxation of overseas income' for the meaning of the terms 'resident' and 'ordinarily resident'.

- Trustees of an interest in possession trust are liable to tax at the basic (20%) or dividend (10%) rate on all trust income whether it is paid out to beneficiaries or not.
    - Where income arises in the UK, tax deducted at source from savings income and tax credits on dividend income cover the trustees' liability in full. Other income, for example, rents from letting property, is taxed at 20%.
    - Trustees are not entitled to personal allowances or any relief for the expenses of managing the trust.
- For 2011/12, trustees of a discretionary or A&M trust have a basic rate band that is equal to £1,000 divided by the number of trusts created by the settlor and in existence at any time during the tax year.
    - This is subject to a minimum of £200 where there are five or more trusts.
    - Income in the basic rate band is taxed at 10% (dividends) or 20% (other income).
    - Above the basic rate band, trustees are liable to tax at 42.5% on dividend income and 50% on savings and other income.

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- ➢ Any tax deducted at source and dividend tax credits are set against these liabilities.
- ➢ Trustees' reasonable expenses are deducted in calculating the higher tax charge but not in calculating the income chargeable at the basic rate. Where there are different types of income the calculation may be complex.
- ➢ There is no personal allowance.
- ➢ There is a complication where trusts distribute dividend income to beneficiaries. The income that the beneficiaries receive is not differentiated by source. To preserve the rule that the 10% tax credit attached to dividends cannot be repaid, trusts that distribute dividend income sometimes have to pay additional tax to ensure that they have paid enough tax to cover the 50% tax credit attached to the beneficiaries' income (see below). Because of this, the distribution of dividend income to beneficiaries may result in the beneficiaries receiving a smaller amount after tax than if they owned the shares personally.
- ➢ The lower tax rates on the basic rate band element may also result in the trustees not paying enough tax to cover the 50% tax credit. If this happens the trustees must make up the difference. This is only likely to occur where the trustees distribute a large proportion of the trust income.

Beneficiaries

Beneficiaries of any type of trust receive the trust income as net income with a credit for the trustees' tax.

- For income from an interest in possession trust, the tax credit is 10% or 20%, depending on whether the income is dividends or other income respectively.
- For income from a discretionary or A&M trust, the tax credit is always 50% (for distributions in 2011/12).
- There is no tax credit with income from a non-resident trust that does not pay UK tax.

The grossed up income is part of the beneficiary's taxable income and the tax credit goes towards the beneficiary's personal tax liability.

- A beneficiary can set personal allowances against income from a trust.
- The tax credit can be wholly or partly repaid where it exceeds the beneficiary's tax liability.
- Basic rate taxpayers will have no further tax to pay on trust income and will be entitled to a repayment if the income carries a 50% tax credit.
- Higher rate (40%) taxpayers will have no further tax to pay and be entitled to a repayment if the income carries a 50% tax credit.
- Additional rate (50%) taxpayers will receive the income with the correct tax deducted.

Settlors

There are two cases where tax law treats trust income as the settlor's. In these instances, the settlor is taxed on the income even if they have not received it. The rules apply to all types of trust.

- The first is where either the settlor or the settlor's spouse or civil partner has retained any interest in the trust. This prevents a taxpayer avoiding income tax by putting assets into a trust while still enjoying a benefit.
- The second is where the trust is for the benefit of an unmarried child of the settlor under 18 years old. The rule extends to any income received by a child that is derived from a gift from a parent.

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- ➢ Income of £100 or less is ignored.
- ➢ There is an exception for certain bare trusts for children created before 9 March 1999. If they meet a number of conditions, the income is taxed as the child's.

Where a settlor is taxable on trust income, the beneficiary is not also liable to tax on that income.

If settlors receive a repayment of tax on trust income, because their personal tax rate is lower than the trustees' rate, they must pass the repayment to the trustees.

A settlor who receives a capital sum from a trust is chargeable to income tax up to the amount of any undistributed trust income.

If the capital sum is more than the undistributed trust income at the time, the excess is carried forward to match against any future undistributed income for up to the next 11 years. A capital sum would include loans and loan repayments.

Capital gains tax

CGT may be payable when assets enter or leave a trust, when trustees dispose of trust assets and sometimes when beneficiaries dispose of their interests in a trust. In addition beneficiaries may be taxable on trust gains under anti-avoidance rules.

Trustees

Trustees treated as UK resident (under the same rules as for income tax) are liable to tax on chargeable gains arising from disposals of trust property under broadly the same CGT rules that apply to individuals.

With two exceptions, trustees are entitled to an annual exemption equal to half the individual annual exemption, so for 2011/12 it is £5,300.

- Certain settlements for the disabled and trusts for vulnerable beneficiaries are entitled to the full individual annual exemption of £10,600.
- Where a settlor has created more than one trust since 6 June 1978, the normal trust exemption is divided equally between them, with a minimum exemption per trust of £1,060.

For this purpose, life assurance policy trusts are included, but registered pension scheme trusts (including those for former retirement annuity policies) are excluded. The creation of several discretionary trusts on successive days can have IHT benefits.

Trustees are taxable at 28% on all gains, regardless of the type of trust.

Trustees can benefit from the private residence exemption on property that a beneficiary occupies as an only or main residence under the terms of the trust.

Property leaving a trust

When a beneficiary becomes absolutely entitled to trust assets, those assets are deemed to have been sold by the trustees at their market value and immediately reacquired by them as a nominee or bare trustee for the beneficiary.

- The trustees are taxable on any chargeable gain that results from this deemed disposal.
- There is no CGT on a distribution in cash.
- In some circumstances, the trustees and beneficiary can elect for the gain to be held over. This means the trustees have no tax to pay. Instead, the gain held over is deducted from the market value of the asset in determining the beneficiary's 'cost' of the asset. When

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the beneficiary disposes of the asset, it is this reduced cost that is used in calculating the beneficiary's chargeable gain.

- ➢ Holdover relief is available on transfers out of any trust where the assets are business assets, for example, shares in an unlisted trading company.
- ➢ Holdover relief is also available on any transfers out of a trust where an exit IHT charge can arise. This includes all discretionary trusts and virtually all trusts created since 22 March 2006.

- There is no CGT when a beneficiary becomes absolutely entitled to settled property because of the death of a beneficiary entitled to an interest in possession for a pre-22 March 2006 trust.
- There is no CGT where a beneficiary's interest ends but the property does not leave the trust.

Property entering a trust

A settlor who transfers property into a trust is liable to CGT as if the property had been sold at its market value. It makes no difference whether or not the settlor is also a beneficiary of the trust.

Provided the settlor does not have an interest in the trust, holdover relief is available where either the assets are business assets or the transfer is a chargeable lifetime transfer (which covers almost all transfers into trusts). The settlor can claim this relief unilaterally.

- A settlor has an interest for this purpose if the settlor or the settlor's spouse or civil partner can benefit from the trust property or there is an arrangement whereby the settlor can benefit in future. There are some limited exceptions.
- Holdover relief that has been given can be clawed back in certain circumstances where the settlor later acquires an interest in the trust.
- Holdover relief is not restricted on transfers to certain trusts for beneficiaries with disabilities.

Disposals of beneficiaries' interests

In general, there is no CGT where a beneficiary disposes of an interest in a trust, unless the beneficiary acquired that interest for money or other valuable consideration.

Settlors' liability on trust gains

Settlors who have an interest in a non-resident trust are liable to CGT on the trust's gains if they are resident or ordinarily resident in the UK in the year in which the gains arise.

A settlor has an interest in the trust if any of the following can benefit in any way:

- The settlor.
- The settlor's spouse or civil partner.
- Any child or stepchild of the settlor or spouse or civil partner, and the spouse or civil partner of any such child.
- Any company controlled by any such persons and any company associated with any such company.

For trusts created after 16 March 1998, or to which property has been added since that date, the settlor has an interest if a grandchild of the settlor or spouse, or the spouse of any such grandchild, can benefit.

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The definition of settlor's spouse does not extend to the widow or widower.

Settlors who are non-UK domiciled are eligible to be taxed under this rule on the remittance basis. They may have to make a claim. See the separate topic 'Residence and domicile and the taxation of overseas income'.

Non-UK domiciled settlors were not liable to UK tax on trust gains up to 5 April 2008. Trustees can elect to exclude unrealised trust gains that accrued up to 5 April 2008 from being taxed.

Beneficiaries' liability on trust gains

Beneficiaries of non-resident trusts are liable to CGT on trust gains if they are either resident or ordinarily resident in the UK.

- Their liability is limited to the amount of any capital payment they receive from the trust. The detailed calculation is complex.
- Notional interest at 10% a year (subject to a maximum of 60%) is added to the tax where there is a delay between the date on which the gain arises in the trust and the making of a capital payment to the beneficiary.
- A beneficiary who is non-resident for a period of less than five complete tax years may be liable to tax on trust gains upon return to the UK.

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Summary

The main income tax, CGT and IHT liabilities are summarised for each type of trust in the following table.

Type of trust	Income tax[1]	Capital gains tax	Inheritance tax
Bare	Beneficiary taxable at own tax rates.	Gift into trust is disposal — holdover relief only on business assets. Beneficiary taxable at own rates on disposals by trust.	Gift into trust is a PET. Assets are treated as if in beneficiary's estate.
Interest in possession	Trustees taxable at 10%/20%. Beneficiary may reclaim/pay extra tax at own rates.	*Pre-22.3.06 trusts:* gift in was disposal — holdover relief only on business assets.[2] Trustees taxable on trust disposals at 28% with trust exemption. Transitional reliefs generally mean deemed disposal on death of life tenant (tax-free uplift) or a beneficiary becoming absolutely entitled to assets — business holdover relief only. *Post-21.3.06 trusts:* as discretionary trust.	*Pre-22.3.06 trusts:* gift into trust was a PET. Transitional reliefs mean assets were generally treated as if in beneficiary's estate. *Post-21.3.06 trusts:* as discretionary trust.
Accumulation and maintenance	Trustees taxable at 50%/42.5%; income in basic rate band of between £200 and £1,000[3] taxed at 10%/20%. Beneficiary may reclaim/pay extra tax at own rates.	*Pre-22.3.06 trusts:* gift in was disposal — holdover relief only on business assets.[2] Trustees taxable on trust disposals at 28% with trust exemption. Holdover relief on assets leaving trust in some circumstances. *Post-21.3.06 trusts:* A&M trusts can no longer be created.	*Pre-22.3.06 trusts:* gift into trust was a PET. No IHT within trust and assets not treated as if in beneficiary's estate. No IHT on property leaving trust. *Post-21.3.06 trusts:* A&M trusts can no longer be created.
Discretionary	Trustees taxable at 50%/42.5%; income in basic rate band of between £200 and £1,000[3] taxed at 10%/20%. Beneficiary may reclaim/pay extra tax at own rates.	Gift in is disposal — holdover relief on any assets.[2] Trustees taxable on trust disposals at 28% with trust exemption. Holdover relief on any assets leaving trust.	Gift into trust is a chargeable lifetime transfer. Periodic charge every 10 years, maximum rate 6%. Exit charge where property leaves trust.

1. Assuming income is not paid to a beneficiary who is a settlor's unmarried child aged under 18.
2. Provided the settlor cannot benefit from the trust.
3. The basic rate band is £1,000 but is reduced if there is more than one trust made by the settlor (minimum of band: £200).

Other taxes

Trustees may occasionally become liable to other taxes. For example, they may be liable to stamp duty land tax (SDLT) when they purchase land. Trustees who trade may have to register for value added tax (VAT).

There are generally no special rules for trusts, and liability is calculated in the same way as for individuals.

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Trusts in tax planning

Trusts have many uses in tax planning. Some uses exploit specific tax reliefs, while in other cases overseas trusts may be used in arrangements that rely more on the secrecy that surrounds them than on their legal efficacy.

Any arrangements that rely on HMRC not finding out are probably illegal (i.e. tax evasion) and carry a risk of penalties if they are discovered. Some contrived arrangements fail in the courts, while others succeed and are then stopped by new legislation, which might be retrospective.

These schemes often focus around either sidestepping the rules that make gifts ineffective for IHT where the settlor retains a benefit or avoiding IHT and CGT at the same time. There is a cycle consisting of the marketing of a new tax-saving scheme, a challenge to it from HMRC (often in the courts), the enactment of new legislation where HMRC loses or is not confident of winning its challenge, and eventually the emergence of new schemes, because anti-avoidance legislation rarely plugs every single loophole or itself creates new loopholes.

To enable HMRC to identify and stop unacceptable tax avoidance schemes more quickly, promoters of income tax, CGT, corporation tax and SDLT avoidance schemes have for some time had to disclose the arrangements to HMRC, which registers them and issues a reference number. This requirement has been extended to IHT schemes first made available after 5 April 2011 that involve a transfer of property into a trust, whether the transfer is immediate or will take place in the future.

Taxpayers who use a registered scheme must show its reference number in their tax return. The fact that a scheme is registered does not mean that it is in any way approved or that it achieves the intended effect.

Entering into complex tax avoidance schemes is a high risk activity and usually involves high costs. Nevertheless, there are uses of trusts that will not be challenged, subject of course to taxpayers declaring all the tax liabilities that do arise and providing complete and accurate information to HMRC. Only a few possibilities are mentioned here.

Inheritance tax planning

Trusts give individuals the opportunity to reduce IHT on their estate by passing assets on during their lifetime without making absolute gifts and by using the nil-rate band on death. Any trusts created during lifetime are only fully effective in reducing tax on an estate if the settlor survives at least seven years.

Discretionary trusts of the nil-rate band

A simple tax planning device is to create a discretionary trust with a gift that falls within the donor’s IHT nil-rate band. No IHT is payable and the donor can elect to hold over any capital gain. IHT ten-year and exit charges are likely to be small or nil.

Discretionary trusts in wills

A discretionary trust of the nil-rate band may also be set up in the will of the first to die of a married couple.

Until 8 October 2007 this was commonly done where the testator wanted to leave all the rest of the assets to the surviving spouse but not waste the nil-rate band.

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Since 9 October 2007 this has become less important because a spouse's nil-rate band is generally not wasted if all assets are left to a surviving spouse.

- When a person has died, any unused nil-rate band can now be transferred to the estate of a surviving spouse or civil partner who dies after 8 October 2007. It does not matter when the first death occurred.
- On the second death, the nil-rate band in force at that time is increased by an amount calculated by the proportion of the nil-rate band that was left unused when the first partner died. The effect is to uplift the first partner's unused nil-rate band to its value at the second partner's death.

However, there can still be a tax advantage in using the nil-rate band on the first death, if it is likely that assets passed down will appreciate in value at a greater rate than the nil-rate band will be uplifted. This is of some importance currently, as the nil-rate band is frozen at £325,000 until 2014/15.

Another reason to use the nil-rate band on first death is that in some circumstances not all the unused nil-rate band can be passed on. This is because the amount of additional nil-rate band that any one surviving spouse or civil partner can accumulate is limited to the value of the nil-rate band in force at the time of that person's death. This restriction may be relevant where either spouse or partner had more than one marriage or civil partnership.

Non-tax considerations are important. For example, individuals may want to ensure that their children inherit their assets. Passing all assets to a spouse or partner on the first death may not waste a nil-rate band, but if the survivor remarries, the family's wealth may never reach the intended beneficiaries. Using a discretionary trust preserves flexibility over how the assets will eventually be distributed.

Another use of discretionary trusts in wills is where the testator wants to leave open the precise distribution of assets among beneficiaries. Although wills can be varied, this requires the consent of all beneficiaries affected and is not possible where any of them are minors.

Again, a discretionary trust is more reliable. If the trust lasts for no more than two years, IHT is the same as if the deceased had made the eventual distribution to the beneficiaries.

Non-domiciled settlors

Under IHT rules, individuals who are not domiciled in the UK lose that status once they have been resident in the UK for 17 out of the previous 20 tax years. An individual who is about to become UK domiciled can prevent overseas assets from becoming liable to IHT by placing them in a trust.

Passing on the family home

Creating a trust to pass on the family home is normally ineffective for IHT because if the settlor continues to live in the home rent-free, this counts as a retained benefit ('gift with reservation'). Schemes involving trusts were devised to try to get around this problem.

The introduction of SDLT on 1 December 2003 made it impossible to avoid SDLT on the sale of the property to the trust. Before then it was possible to avoid stamp duty by not completing the sale.

From 6 April 2005, income tax ('pre-owned assets' tax) is charged on the benefit people get by having free or low cost enjoyment or use of certain assets they formerly owned, or provided the funds to purchase. The charge is designed to penalise those IHT saving schemes that bypass the gifts with reservation rules. It applies to all arrangements set up from 18 March 1986 onwards if the former owner of an asset still enjoys a benefit, with some limited exceptions.

To avoid income tax, taxpayers may be able to undo the arrangement. If this is not possible, they can avoid income tax by electing for the asset to be subject to IHT on death.

- In principle, the election must be made by 31 January following the end of the first tax year in which income tax arises. For 2005/06, the election therefore should have been made

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by 31 January 2007. However, HMRC has the discretion to accept late elections without restriction.

- If an election is made, the property in question is treated as part of the former owner's taxable estate for IHT purposes, while they continue to enjoy it, in essentially the same way as under the 'gift with reservation' rules.

The income tax charge on 'pre-owned assets' is not limited to arrangements involving property or even arrangements involving trusts, but also extends to chattels (tangible movable assets, such as works of art) and financial products.

Insurance and pensions

It is possible to enter into an insurance policy that will pay out a lump sum on death that can be used to pay IHT. Such policies should be written in trust so that the payout falls out of the estate.

Premiums paid would normally be covered by the IHT annual and normal expenditure from income exemptions.

The same is true for death benefits under pension schemes, which are exempt from the changes in the Finance Act 2006.

Capital gains tax planning

Extensive anti-avoidance legislation has made trusts an ineffective vehicle for reducing tax on chargeable gains.

Crystallising a gain

Occasionally it is beneficial for an individual to crystallise a gain for tax purposes. A disposal into a trust in which the settlor is also a beneficiary can achieve this without loss of ownership of the asset.

Income tax

It is possible for individuals to avoid tax on overseas income through using an overseas trust, as the trustees are not taxable in the UK. However, the settlor must not be in a position to benefit from the trust. There is also legislation that taxes income from assets that have been transferred abroad in some circumstances.

Tax planning key points

- Trusts have many legitimate uses and should be considered in any estate planning exercise.
- However, there are many circumstances in which tax can arise in connection with trusts. Care must be taken that the settlor is not merely exchanging one tax liability for another.
- Anyone who enters into any arrangements involving trusts should make sure they understand in advance all the risks involved and what fees will be charged, especially for overseas trusts, which are often costly to administer.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.

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