An Introduction to Trusts

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Introduction to Carol Wells

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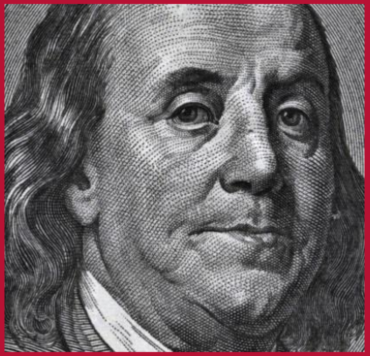
- Chartered Tax Adviser
- Background in accountancy firms and last 13 years with Irwin Mitchell Solicitors
- Joined Abbey Tax in January 2017
- Specialise in estate planning advice and taxation of trusts
- Will drafting, trust preparation and LPAs
- Role is to provide IHT Consultancy Services

"In this world nothing can be said to be certain, except death and taxes."



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Content today

- What are trusts used for?
- Who uses trusts?
- Types of trusts
- The taxation of trusts

What are trusts used for?

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- Protection
  - For the benefit of the beneficiaries
    - Minors
    - Disabled
    - Vulnerable or disabled
- Control
- Tax planning

Who uses trusts?

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- More people than you think……….
  - The wealthy
  - Families with disabled members
  - Individuals who have suffered a personal injury
  - Disabled and elderly individuals
  - Members of pension schemes
  - Holders of life assurance
  - Grandparents
  - Parents
  - Pension schemes when a member dies

Types of trusts

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Absolute trusts

- Bare Trust
  - Personal injury
  - Simple trusts
  - Beneficiary can call for transfer of whole trust fund

Defined interest trusts

- Interest in Possession
  - Beneficiary has a right to income but not to capital
  - Possibly for lifetime or fixed period
  - Trustees may have discretion over capital appointment

Discretionary trusts

- Relevant Property
  - Discretionary trust
  - Beneficiaries have no automatic right to income or capital
  - Trustees have full control over income and capital

The taxation of trusts

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- Taxes to consider:
  - Income tax
  - Capital gains tax
  - Inheritance tax
- All vary depending on the type of trust involved
- Trust taxation largely aligned from 6 April 2008

Absolute trusts

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- Look through the trust to the underlying beneficiary
- All tax liabilities fall on the beneficiary as the trust fund is theirs
- No CGT exemption
- The Trustees are there to provide either:
  - A veil; or
  - Independent control to protect the beneficiary
- Trust fund part of the beneficiary's estate
- Not affected by 2008 changes

Defined interest trusts

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- Income taxed on the beneficiary even if retained in the trust
- Trustees may mandate income to be paid directly to the beneficiary
- Gross income taxed in the trust at basic rate only
- Any higher rate tax payable by the beneficiary
- 50% of individual's CGT exemption
- Gains taxed in the trust at 20% unless residential property then at 28%
- IHT position depends on when and how the trust was established

IHT on defined interest trusts

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- Pre 2008 Interest in Possession trusts
  - Deemed to form part of the life tenant's estate
- Post 2008 IIP's created in lifetime
  - Now within relevant property regime
    - Ten year charges
    - Exit charges
- Will trusts
  - Deemed to form part of the life tenant's estate

Discretionary trusts

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- Income taxed in the trust at the RAT
- RAT
  - first £1000 at 20% (apportioned between all trusts set up by the same settlor)
  - Balance:
    - Dividend income at 38.1%
    - All other income at 45%
- Tax pool
  - Year on year cumulative total of tax paid by the trust
  - Used to ‘frank’ distributions to beneficiaries
- 45% tax credit on income payments to beneficiaries

Illustration of income tax for discretionary trusts

- Trust receives the following income:
  - Interest - net - £10,000 - gross £12,500
  - Rental income - gross £15,000
  - Dividends - net - £7500 - gross £ 8,333
  - Total income **£35,833**
- Tax thereon:
  - First £1000 @ 20% £ 200
  - Balance of dividends @ 38.1% £ 2,793.88
  - Balance at 45% £12,375
  - Total tax payable credited to TP £15,368.88
  - Less tax deducted at source £ 3,333.33
  - Net tax due £12,035.55

What if the Trustees make an income payment?

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- Trustees pay £10,000 of income to beneficiary
- Deemed to be net of 45% tax
- Gross income paid therefore £18,181
- Tax thereon @ 45% £8,181
- Tax pool per previous slide £15,368
- Less tax on distribution £ 8,181
- Balance of tax pool c/fwd £ 7,187

What if the Trustees paid £20,000 of income net?

• Grossed up income is	£36,363
• Tax thereon at 45% is	£16,363
• Tax pool	£15,368
• Less needed to frank income payment	£16,363
• Shortfall	£ 995

The shortfall is an additional liability for the trustees

Beneficiary's tax position

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- Net trust income received of £10000
- Gross income £18,181
- No other source of income

Gross income	£18,181
Less personal allowance	£11,000
Taxable	£ 7,181
Tax due @ 20%	£ 1,436
Tax paid	£ 8,181
Repayment due	£ 6,745

2nd Beneficiary's tax position

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• Net trust income received of £20000, gross	£36,363
• Less personal allowance	£11,000
• Taxable	£25,363
• Tax due @ 20%	£ 5,072
• Tax paid	£16,363
• Repayment due	£11,291

Capital gains tax in discretionary trusts

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- Annual exemption half the individual's - £5,550
- Gains taxed at 20%/28%

Inheritance tax for discretionary trusts

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- Known as ‘relevant property’ trusts
- Separate estate for IHT
- Subject to IHT on creation if more than £325k unless BPR/APR apply or the transfer into trust is income from the settlor
- Tax is based on 30% of the lifetime rate of 20% apportioned on a time basis in relation to 10 year anniversaries
  - Effective rate of tax no more than 6%
- Trust has own nil rate band
- Charges arise on every 10 year anniversary
- And on distributions between anniversaries

Calculation of tax on 10 yr charge

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- Trust worth £500,000
- No capital added in previous 10 years
- No distributions have been made
- Trust capital all investments
- Tax due:

	500,000
Less nil rate band	325,000
Taxable	175,000
Tax due at 30% x 20% is 6%	10,500
Effective rate of tax	2.1%

IHT on capital distributions

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- Based on the number of quarters since the last 10 year charge
- Calculated at the effective rate of tax on the previous 10 year charge

Example continued

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- 1 year after the previous 10 year charge the Trustees decide to appoint £100,000 to a beneficiary
- The IHT payable is:
  - £100,000 x 2.1% (effective rate on last 10 yr charge - £2,100
  - Restricted to the number of complete quarters
  - since the last 10 year charge ie 4/40 £210

Pitfalls of discretionary trusts

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- Dividends cannot be fully distributed as 45% credit must be given but the trust only pays tax at 38.1%
- Not all income can be distributed because of the effect of the lower rate band, unless additional tax paid by the trust
- Timing difference between when the trustees pay the tax and when the beneficiary can recover
- IHT charges are easy to overlook leading to penalties
- The amount of IHT payable often disproportionate to the cost of preparing the returns

Advantages of discretionary trusts

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- Outside of the individual's estate therefore not taxed on death
- Strong control element
- No automatic right to income or capital
- Useful asset protection tool for family wealth
- Good way of transferring income to lower rate tax paying beneficiaries
- Capital can be transferred into trust without incurring CGT – hold over relief
- Very flexible

Will Trusts

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- Asset protection vehicles
  - Protect the estate for secondary beneficiaries
  - Remarriage scenario
  - Care fees
  - Disabled or vulnerable beneficiaries
- Valuation advantages
  - Reduce value of estate subject to IHT
- Tax planning
  - Loans rather than capital appointments
  - BPR shelter
  - Maximising transferable nil rate bands where widows remarry

Maximising nil rate bands for widows

- Widow remarries
- 1st husband's estate passed to her
- Her estate is worth more than £650k
- Second husband's estate worth at least £325k
- Total combined estates worth £975k

Potential for the whole estate to pass free of tax if Wills are drafted appropriately

How does this work in practice?

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- Husband draws up a Will which leaves his nil rate band into trust if he dies first, or to his beneficiaries direct if he dies second
- Wife draws up a Will which leaves first £325k into trust and balance to husband either outright or in trust
- If husband dies first then his nil rate band is used on the gift into trust
- If wife dies first, her previous husband's transferable nil rate band is claimed against her gift into trust
- Then when husband dies his own nil rate band is available plus his wife's transferable nil rate band

Also works where both spouses are widowed – 4 NRBs
£1.3m NRB

Also works with the new residential nil rate band
£2.0m NRB

Careful drafting of Wills and advice needed

Any questions…………

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