Comings and goings

John Colville reviews the tax issues for transfers in and out of UK trusts.

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Whisper it quietly, but trusts are relatively simple things when they are boiled down to the fundamentals and we are not distracted or confused by the 'legal speak' in which they are wrapped up.

People (settlors) put things (assets) into a 'large cardboard box' to be kept safe and accessed at a later date (a trust). The trustees look after the box for a while and, in the meantime, the assets in the box generate income and grow in value. Then, on the principle that everything that goes in the box must eventually come out again, when the time is right (or when they are obliged to under the rules of the trust), the trustees will take those assets out of the box and give them to the people (beneficiaries) for whom the trust was set up in the first place.

Our job is to deal with the tax side of these comings and goings. 'That must be complex,' they say. But it is not if we know the basic principles. This is what we want to reinforce here as these basics are the cornerstone of any ATT or CTA exam question and any practice situation which involves the creation or winding-up of a UK trust.

Things going in...

Most of the time if a settlor transfers assets to a trust, inheritance tax will have to be paid. It is in effect an 'entrance fee'. There are very few occasions nowadays when the lifetime creation of a trust is not accompanied by an inheritance tax entry charge – disabled persons' trusts and bare trusts are about it – and we are not going to address those in this article.

In simple terms, the inheritance tax entry charge is the excess of the value of the assets going in (calculated using 'loss to donor' rules), less the nil rate band, multiplied by the entry rate. The entry rate is usually 25% because the donor typically has to pay the tax – at this point the trust has no money. If the trustees pay the tax, the entry rate is 20%. We might be able to deduct a couple of annual exemptions and it is necessary to look back seven years to see if a previous gift to trust has 'stolen' all or part of the available nil band, but in essence, that is it.

The capital gains tax side is more involved but, again, stick to basic principles.

A gift of a chargeable asset – for example, shares, land and property – to a trust is a disposal by the settlor, and for capital gains tax this is treated in the same way as a sale at full market value. If the market value of the asset going into trust exceeds its base cost, a gain will arise.

Step 1 is to calculate that gain (normally quite straightforward). Step 2 is to decide what to do with it.

The settlor could pay the capital gains tax. In some cases the settlor has no choice in this matter, even though there are no proceeds from which to pay the tax. The trust will then take the assets with a capital gains tax base cost equal to market value.

However in most cases, the gain on entry can be deferred because gift relief (TCGA 1992, s 260) is available whenever the gift is immediately chargeable to inheritance tax. The type of asset here is irrelevant. Very few lifetime gifts into trusts are not immediately chargeable to inheritance tax, so gift relief is generally the weapon of choice in Step 2 because the settlor is unlikely to want to voluntarily pay capital gains tax if this can be avoided. The gift relief claim reduces the settlor's gain to zero. The trustees inherit the settlor's capital gains tax base cost.

Well almost. The trustees can increase their capital gains tax base cost by adding on any inheritance tax on the asset

Key points

- Trusts are relatively simple when boiled down to the fundamentals.
- Most of the time if a settlor transfers assets to a trust, inheritance tax will have to be paid.
- The entry rate is usually 25% because the donor typically has to pay the tax. If the trustees pay the tax, the entry rate is 20%.
- The capital gains tax side is more complex.

which is paid on entry (on the grounds that the inheritance tax paid is an additional cost of acquiring the asset). This is the case regardless of whether any gift relief has been claimed and regardless of who pays the inheritance tax. Capital gains tax relief for inheritance tax paid is a relief which is regularly forgotten by practitioners and exam candidates alike which is a pity as it can be very valuable. (In the exam, students should not worry if they do not calculate the relief correctly – the fact they spotted the base cost uplift in the first place will attract most of the credit.)

There are a couple of occasions when gift relief is denied on a transfer into trust despite the fact that there is an inheritance tax entry charge:

a) If the trust is non-UK resident (even then gift relief is still available for transfers of UK land and property as such assets remain chargeable to capital gains tax in the hands of non-resident persons under the non-resident capital gains regime); or
b) If the beneficiaries of the trust include the settlor, their spouse or their minor children.

Under b), if the trust is to be established for the settlor's young children and the capital gains tax on entry would otherwise be expensive, the advice is either to delay the creation of the trust until all of the children reach the age of 18 (which is not always desirable or practical), or simply exclude the younger ones and add them as formal beneficiaries from their 18th birthday (just accumulate their 'share' in the meantime). This will secure gift relief on entry.

Things coming out...

What goes in must eventually come out. The trustees can either:

a) sell the assets and appoint the cash proceeds to the beneficiaries; or
b) distribute the assets themselves and let the beneficiaries sell them.

Much of the time this appears to be 'swings and roundabouts' in terms of the tax liability, although there tends to be a capital gains tax advantage in option b) as we shall see.

Trustees' sales of assets are quite straightforward. Proceeds less capital gains tax base cost equals gain. It may be necessary to jump through a couple of hoops to arrive at the base cost if capital gains tax gift relief was claimed when the asset entered the trust (in which case look out for the uplift in base cost for any inheritance tax paid).

Trustees have an annual exempt amount (AEA) equal to 50% of the standard AEA (potentially divided up if the settlor has been a serial trust creator). Gains above the that sum are taxed at 20% unless the asset sold is UK residential property in which case use 28%. Remember that trustees (as is the case for individuals) are required to submit online land and property returns and pay the tax within 30 days of completion of a UK residential property disposal or penalties will be triggered.

Trusts can access business asset disposal relief and pay capital gains tax at 10%, but this is relatively rare and requires an interest in possession trust and a beneficiary happening to have a 5% interest and being a director/employee of the company in which the trust is selling shares.

What this will leave is cash in the trust which the trustees can distribute. At this point, our thoughts return to inheritance tax.

Most trusts are 'relevant property' trusts meaning that they are subject to exit charges on capital appointments and principal charges – or 'periodic' or 'ten-year' charges – on each ten-year anniversary. There are proformas to calculate these charges which must be committed to memory (unless it is an open-book exam).

There are no exit and principal charges in 'qualifying interest in possession' (QIIP) trusts. These sit outside the relevant property regime and instead the assets of the QIIP trust are treated as forming part of the estate of the beneficiary with the IIP. Such trusts are not as common and are largely outside the scope of this article. If however we assume that all pre-March 2006 IIP trusts and IIP trusts set up on death are QIIPs and every other trust is a relevant property trust, that will be right 99% of the time.

Where assets are appointed to beneficiaries, the capital gains tax treatment will be dictated by the inheritance tax.

The gift of an asset (this time from trust to beneficiary) is a disposal at market value giving rise to a capital gain. Step 1 is to calculate that gain. Step 2 is to decide what to do with it. Same idea – different situation.

If the appointment of an asset gives rise to an exit charge (which it normally will), TCGA 1992, s 260 gift relief will almost always be available. The trustees' gain is reduced to nil. The beneficiary inherits the trustees' capital gains tax base cost. We've been here before.

Once again the beneficiary can increase their capital gains tax base cost by adding on any inheritance tax on the asset which is paid on exit (same idea, same probability of this being forgotten). Which is a shame because the capital gains tax relief for the inheritance tax paid will usually mean that it is cheaper in terms of capital gains tax for the trustees to appoint the asset to a beneficiary (with a gift relief claim and an uplift in the base cost for the inheritance tax paid) and for the beneficiary to then sell that asset in their own right.

Also bear in mind that the beneficiary has a higher capital gains tax AEA than the trustees and may be liable to capital gains tax at the lower rates of 10% and 18% which are not available to trusts. Also where assets are being appointed to several beneficiaries – as is often the case in discretionary trusts – each beneficiary can use their own AEA, rather than having one AEA to set against trust gains.

Occasionally a capital appointment does not give rise to an exit charge, most commonly:

- in QIIP trusts; and
- in relevant property trusts where the trustees are daft enough to have appointed assets within three months of a principal charge in which case the effective exit charge rate is nil (due to 'n' being zero) which does not then create a chargeable transfer. Some call this a trap but it is just a rule.

All is not lost for capital gains tax in these cases because gift relief may be available under TCGA 1992, s 165 if the asset gifted is a business asset (most commonly shares in unlisted trading companies or farmland). There is no relief for inheritance tax paid in this case for the simple reason that no inheritance tax has been paid.

Be aware that gift relief claims on assets leaving the trust must be made jointly by the trustees and the beneficiary. This is different for assets going into the trust where only the settlor is required to sign the claim form.

In all cases, capital gains tax gift relief must be claimed no later than four years from the end of the tax year of the gift (always worth a mark in an exam question) although in reality we tend not to wait that long and instead claims are made when the relevant self-assessment return is filed; this prevents HMRC trying to collect the tax which would otherwise be due.

And finally

Here are few final planning points.

- If a property is appointed from a trust to a beneficiary and a TCGA 1992, s 260 gift relief claim is made, the beneficiary cannot then claim principal private residence relief on a sale of that property in the future. This is something to consider if a house is being appointed to a beneficiary who then intends to live in it either immediately or at some point in the future. In these cases it may be better for the trustees not to make a s 260 claim and instead pay the capital gains tax due on the appointment. The beneficiary will then have the benefit of both a higher capital gains tax base cost and, more importantly, the possibility of any future increase in the value of the property being covered or mitigated by principal private residence relief.
- If faced with a situation where assets are being appointed to a beneficiary who is non-UK resident – when capital gains tax gift relief will be denied – appoint assets which are either not chargeable to capital gains tax, such as cash, or 'cherry pick' assets on which gains are lowest.
- Where a trust is being wound up and assets are to be appointed, always look at the tax pool. This is a handy little reservoir of 45% tax credits which beneficiaries can use if income is distributed to them. Do not waste these tax credits. Make income distributions to clear out the tax pool. As most beneficiaries are not 45% taxpayers, they can then reclaim some or all of these tax credits. Stripping out cash as income also then reduces the amount which is subject to an exit charge.

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