Types of trust - an overview

Synopsis: A short description of the main types of trust in use in the UK.

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The subject of trust taxation covers income tax, capital gains tax (CGT) and inheritance tax (IHT). An understanding of trust taxation will enable a financial adviser to better identify investment opportunities.

Essentially, a financial adviser is required to have an understanding of the principles of taxation to give investment advice to individuals. In the same way an understanding of trust taxation equips financial advisers with the ability to give investment advice to trustees.

A tax liability in connection with a trust can arise on many different occasions such as...

- Setting up a trust.
- Changing the terms of a trust.
- Managing trust investments, e.g. receiving income and making capital gains on the disposal of assets.
- Making payments out of a trust.
- Termination of a trust.
- Death of a beneficiary with a vested right to income or capital.
- In the case of discretionary trusts - at periodic intervals regardless of whether there are any dealings with the trust property.

In addition, one has to consider the position in relation to each of the parties to the trust, i.e. the settlor, the trustees and the beneficiaries.

In short, it is necessary to consider...

- Who is subject to income tax, CGT and IHT, and at what rate.
- When will any of these taxes become payable.
- Under which type of trust these taxes can become payable.

First, it is necessary to consider the main types of trust in use in the UK.

Trusts can take many different forms but the following are the major types of trusts which are commonly used

Following the changes to the IHT treatment of trusts introduced in the Budget 2006, all lifetime trusts, other than absolute trusts and trusts for the disabled, are now taxed in the same way for IHT purposes, i.e. as fully discretionary trusts.

Absolute (bare) trusts

Here, both capital and income are held by the trustees for the absolute benefit of the beneficiary or beneficiaries, normally a minor child or children.

A feature of these trusts is their total inflexibility but they can give some tax advantages, which are discussed later.

Interest in possession trusts

Here a beneficiary has an immediate legal entitlement to any income (e.g. interest, dividend income, rents, etc.) produced by the trust property as and when that income arises.

Such a trust is frequently created when the settlor wishes a person to have the guaranteed use of income from certain property during their lifetime but does not want the beneficiary to have outright access to the capital - this is known as a "life tenancy" and is often used in the Wills of married couples and members of a civil partnership who wish to ensure that the capital value of assets of the first to die pass, intact, to the next generation but wish to give the surviving spouse/civil partner the right to income for life.

A right to income may however exist for a defined period, say a number of years or until re-marriage/forming a new civil partnership.

Often, despite the immediate entitlement to income, the trustees (or the settlor) would have the power to appoint the right to the trust capital or future income to other beneficiaries in a stated class.

Alternatively, the trust may provide in fixed terms for the subsequent destination of trust income and capital, e.g. income to X for life, then income to Y for ten years and after that capital and income to A and B.

Prior to 22 March 2006, all interest in possession trusts were treated favourably for IHT purposes in that lifetime gifts to such trusts were treated as potentially exempt transfers (PETs), or as exempt transfers if in favour of the donor’s spouse/civil partner, and the trusts were not subject to the relevant property regime which applies to discretionary trusts.

From 22 March 2006, new lifetime interest in possession trusts, other than trusts for the disabled, are treated, for IHT purposes, in the same way as fully discretionary trusts. Pre-22 March 2006 trusts had until 5 October 2008 to reorganise their affairs in order to benefit from transitional provisions.

New types of interest in possession were created in Sch 20 Finance Act 2006 which retain the favourable IHT treatment – these are: immediate post-death interests (IPDIs), transitional serial interests (TSIs) and disabled person’s interests (DPIs).

Discretionary trusts

As the name suggests, a discretionary trust gives the trustees complete discretion as to the use of capital and the distribution of income.

In the trust document the settlor provides the trustees with a description of the classes of people who are to potentially benefit but the final decision as to the level and frequency of payments is left to the trustees.

This means that until a distribution or appointment is made under the terms of the trust no beneficiary has the right to income or capital. Any trust income which is not distributed is accumulated (during the accumulation period) and becomes capital.

Accumulation and maintenance (A&M) trusts

This is a type of discretionary trust, which exists primarily to enable the settlor´s children or grandchildren to benefit from at least trust income either when they reach age 18 or within a few years afterwards (but at the very latest by the time they attain age 25). Until the 2006 Budget, provided the trust fulfilled certain conditions it was more favourably treated for IHT purposes than a traditional discretionary trust. The conditions were...

- One or more persons will become entitled to the trust capital (or an interest in possession - right to income - in it) before they attain 25 years of age, and...

- Until that time the trust income is accumulated as an accretion to capital so far as it is not applied for the maintenance, education or benefit of a beneficiary, and...

- Either all the beneficiaries are grandchildren of a common grandparent (or children/widows/widowers of such grandchildren if they die before becoming entitled),

or

- Not more than 25 years have elapsed since the commencement of the settlement.

During the accumulation period it would usually be possible to advance capital to or for the benefit of the beneficiaries or pay or apply income for their benefit without giving any rights to income until the specified time.

Paragraph 2 of Schedule 20 Finance Act 2006 provides that the pre-Budget rules on A&M trusts (section 71 IHTA 1984) will not apply to property settled on or after 22 March 2006. Existing A&M trusts were allowed transitional treatment on the pre-Budget basis until 6 April 2008. An existing trust under which the beneficiary becomes absolutely entitled at age 18, (or an existing trust amended before 6 April 2008 to provide for this), continues to benefit from the favourable IHT treatment (i.e. no periodic or exit charges). If an existing A&M trust was amended before 6 April 2008 to satisfy the 18-to-25 trust conditions (or already satisfied those conditions), it is treated in the same way as an 18-to-25 trust. Other A&M trusts are now charged to IHT in the same way as discretionary trusts.

CGT hold-over relief

A transfer into an old A&M trust was a PET. Since IHT was not chargeable, gift hold-over relief (under s260 TCGA 1992) was not available. When dealing with old A&M trusts, it may be assumed that the base cost of non-business assets has not been reduced by a gift hold-over claim. (The position may be different if the gift into trust qualified for business asset hold-over relief under s165 TCGA 1992.)

A transfer out of an old A&M trust does, however, qualify for gift hold-over relief, regardless of its current status...

- If it retains its A&M status, it qualifies under s 260(2)(d) TCGA 1992.
- If it has become an 18–to-25 trust, it qualifies under s 260(2)(db) TCGA 1992.
- If it has become relevant property, it qualifies under the standard criterion of being a chargeable transfer s 260(2)(a)) TCGA 1992.

The FA 2004 restriction for settlor-interested trusts (under s169B TCGA 1992) applies only to property entering, and not to property leaving, such trusts.

Lifetime trusts and trusts created on death

For tax purposes any trust will fall into one of the above categories, i.e. it will be either a bare (absolute) trust, an interest in possession trust, a discretionary trust or an A&M trust. The type of trust and the occasion of its creation will determine how the trust is taxed as the rules differ for different types of trust, and, also, since the Budget 2006, depending on whether certain trusts are created on death or during lifetime.

Any of the above-mentioned main types of trust can be created by an individual during their lifetime or in a Will. In the latter case, of course, the trust will only come into operation on the individual's death provided the Will remains valid.

Until Budget 2006 for tax purposes it generally did not matter whether a trust was created during lifetime or on death, although there were circumstances where it was important, in particular in respect of the settlement anti-avoidance provisions for trusts under which the settlor or spouse/civil partner could benefit where such anti-avoidance provisions would only apply during the lifetime of the settlor.

Following the changes to the taxation of trusts after the Budget 2006 for IHT purposes, there are now numerous new rules which treat certain lifetime trusts in a different way from trusts coming into effect on death. There are therefore occasions where the same trust will be taxed in a different way during the lifetime of the settlor and after their death.

Another type of trust that can only arise on death is a statutory trust created on intestacy. There are two types of such a trust, depending on whether only the children can benefit or also a surviving spouse/civil partner. If there is a surviving spouse/civil partner, there will be a life interest for the spouse/civil partner with the children becoming entitled on his/her death.

If there are minor children, the trust of their share will be a statutory trust for bereaved minors (TBM) under Sch 20 Finance Act 2006 (please see below). Prior to the Budget 2006 it would have been a statutory A&M trust.

Trusts under Finance Act 2006

Two new types of trust were introduced by Finance Act 2006. These are TBMs (please see above) and "age 18-to-25 trusts". These can only be set up on the death of a parent (including step-parent) for a minor child.

All trusts created for a minor child on the intestacy of a parent will be TBMs whereas a Will may create a TBM or an age 18-to-25 trust. Under a TBM the beneficiary must become absolutely entitled at age 18. Under an age 18-to-25 trust, the trust can continue beyond age 18 as long as the beneficiary takes the trust assets absolutely not later than age 25. TBMs are not subject to the discretionary trust charging regime and age 18-to-25 trusts only become subject to the regime on payments out of the trust after age 18, with a maximum possible IHT charge at 4.2% on the latest possible distribution at age 25. There are no entry or periodic charges under an age 18-to-25 trust.

The treatment for age 18-to-25 trusts will also apply to existing A&M trusts – in this case whether created on death or during lifetime – provided the trust was amended before 6 April 2008 to include an absolute entitlement by age 25 (or already provided for this to happen) as mentioned above.

All other trusts (other than bare trusts) are now subject to the discretionary IHT charges in the same way as fully discretionary trusts.

Disabled persons trusts

Trusts established for disabled persons offer IHT and CGT advantages, which are considered below.

IHT

Property transferred into a settlement after 9 March 1981 which is held on discretionary trusts primarily for the benefit of a disabled person is treated by virtue of section 89(1) IHTA 1984 as if the disabled person has an interest in possession in the trust property even though in strict terms, there must be no actual interest in possession under the trust.

Under the provisions introduced in Sch 20 Finance Act 2006, an interest in possession which satisfies the conditions of a "DPI" (please see above) retains its previous IHT treatment (i.e. the property being included in the disabled person's estate for IHT purposes).

This applies regardless of when the trust was created. The provisions have also been extended trusts under which the disabled person has an actual interest in possession; as well as trusts created by a person who expects to become disabled in the future and establishes a trust to provide for their future needs ('self-settlements').

The definition of a disabled person is provided by Schedule 1A Finance Act 2005 (as extended by Finance Act 2013 to reflect the introduction of Personal Independence Payment (PIP)) and includes...

- A person unable to administer their property or manage their affairs because of mental disorder within the meaning of the Mental Health Act 1983;

- Or qualifies under a 'benefits' test, i.e...

  - is eligible for an increased disablement pension, or

  - is eligible for attendance allowance, or

  - is eligible for the care component of disability living allowance at the highest or middle rate, or the mobility component of disability living allowance at the higher rate, or

  - is eligible for the personal independence payment, or

  - is eligible for an armed forces independence payment.

Qualification as a disabled person by being in receipt of only the mobility components of disability living allowance or personal independence payment came in for the year 2014/15 and later years as a result of changes made by Finance Act 2014.

In addition, the trust must ensure that during the lifetime of the disabled person (or until the termination of the trust, if earlier)...

- If any of the property is applied for the benefit of a beneficiary, it is applied for the benefit of the disabled person; and...

- Either the disabled person is entitled to all the income arising from the property or, if the disabled person is not entitled to all of it, none of the income can be applied for the benefit of anyone else.

This is subject to a de minimis rule that allows the trustees to apply 'modest amounts' (£3,000 or 3% whichever is lower) of capital or income for the benefit of persons other than the vulnerable person in the tax year.

Such a trust may be appropriate where a donor wishes to provide for a disabled person and to ensure that property surplus to the requirements of the disabled person may be accumulated and ultimately used for the benefit of others.

Trusts that meet the qualifying criteria will suffer no IHT charge under the discretionary trust regime but will be taxed as though the disabled person has an interest in possession in the settled property (despite the fact that the trust may be discretionary in nature). Therefore, any transfers into such a trust will count as PETs (unless the trust is a self-settlement in which case the transfer is not a chargeable occasion) and the trust will not be subject to the relevant property provisions (i.e. no periodic or exit charges even if the trust is discretionary).

CGT

Historically, the provisions of section 89 IHTA 1984, and those in TCGA 1992, Sch 1 (relating to the CGT annual exemption available to trustees of a trust for a disabled person) did not fit together. This was because Schedule 1 TCGA 1992 provided that the CGT annual exemption would only be available to the trustees in full where the disabled person had an interest in possession; while the provisions of section 89 required that there was none. This meant that it was difficult to secure both favourable IHT and CGT treatment without complex drafting.

Since Finance Act 2013, the rules have been aligned across the taxes so that the conditions that must be satisfied are essentially the same for both CGT and IHT.

Further where the disabled person has an interest in possession in the trust, sections 72 and 73 TCGA 1992 provide that even though the death of the disabled person will not be an occasion of charge to CGT, the trust assets will then benefit from an uplift to market value in the same way as they would do if held by the disabled person directly.

Legislation included in Finance Bill 2014 extends sections 72 and 73 of the TCGA to include qualifying trusts for disabled beneficiaries where the beneficiary has no entitlement to the income of the trust.

As an alternative (and provided all the qualifying criteria are met), the trustees are able to elect to be taxed on the basis of the disabled person's individual circumstances, for both income tax and CGT, in accordance with the 'vulnerable beneficiary' regime (please see below).

Personal injury trusts

It is important to distinguish a trust for the disabled from a personal injury trust.

Whilst under both the primary beneficiary will be a disabled person, under a disabled trust a third party will usually establish the trust with their funds (although as mentioned above, self-settlements are now permitted). Under a personal injury trust (also known as a "special needs" trust) the trust is always established with the primary beneficiary's own money, which will have arisen from an award of damages for injuries. As the primary beneficiary is generally the settlor of the trust any income and capital gains will be assessed to tax on them regardless of any special provision and, of course, the value of the trust assets would be treated as forming part of their estate on death.

Nonetheless, if the primary beneficiary meets the definition of a disabled person and the trust is drafted to include the appropriate restrictions on application of income and capital, the trust will not be subject to IHT periodic and exit charges even if discretionary in nature.

The key point is that 'personal injury trust' is simply a generic term used to refer to any trust established with a personal injury award. It can take any form and will only benefit from preferential IHT treatment if it fulfills the criteria for a disabled trust. Usually, personal injury trusts are created to protect means-tested benefits from being impacted by the capital value of the award.

For details of trusts for the most vulnerable please see below.

Trusts for the vulnerable

These trusts were introduced by Finance Act 2005, following an announcement made in the 2004 Budget.

The special regime, which was backdated to commence from 6 April 2004, allows qualifying trusts to be taxed on the basis of the vulnerable beneficiary's individual circumstances for both income tax and CGT.

To benefit from the special tax regime, there must be both a 'vulnerable beneficiary' and a 'qualifying trust'.

Broadly, a vulnerable beneficiary is either a disabled person (as defined in Schedule 1A Finance Act 2005 – please see above) or minor child at least one of whose parents has died (a 'relevant minor').

While the precise definition of a qualifying trust is slightly different depending on whether the trust is a trust for a relevant minor or a disabled person, the basic premise is that the trust must ensure that during the lifetime of the vulnerable person (or until the termination of the trust, if earlier)…

- If any of the property is applied for the benefit of a beneficiary, it is applied for the benefit of the vulnerable person; and…

- Either the vulnerable person is entitled to all the income arising from the property, or, if the vulnerable person is not entitled to all of it, none of the income can be applied for the benefit of anyone else.

This is subject to a de minimis rule that allows the trustees to apply 'modest amounts' (£3,000 or 3% whichever is lower) of capital or income for the benefit of persons other than the vulnerable person in the tax year.

There are further requirements that must be satisfied for a trust for a minor to qualify.

Broadly it must have been set up either under the intestacy rules or under the terms of the parent's Will and if created in the deceased parent's Will it must give the beneficiary unconditional entitlement at the age of 18, i.e. a TBM – please see above for an explanation. Where a trust is created for minor children of a deceased on intestacy, this will also be a TBM under which the beneficiary will become absolutely entitled to both income and capital at age 18.

When a trust is treated as a trust for the most vulnerable, the trustees are able to elect to be taxed on the basis of the vulnerable beneficiary's individual circumstances, for both income tax and CGT, in effect treating the trust as a bare trust for the vulnerable beneficiary.

The election is made jointly by the trustees and the beneficiary - where the beneficiary is incapable of making an election, for example because they are a minor, it will be made by their parent or guardian. The election is irrevocable - this is largely to ensure that there is no manipulation of the system to obtain tax benefits.

Note that if there is an unconditional legacy to a child under a Will, this would normally be an absolute trust in which case the beneficiary will be assessed to income tax and CGT in any event. The opportunity created by the above provisions is for Will trusts which are in the form of an A&M trust until the child´s 18th birthday or which only allow the child a right to income until the age of 18 and capital on survival to 18. Such trusts are now effectively treated as bare trusts if a suitable election is made.