Taxation of trusts reform

Synopsis: Effect on UK trust taxation of the reform being implemented since 2003.

Date published: 24.05.2024

The programme of reform of the taxation of trusts started in 2003.

The Pre-Budget Report in December 2003 announced a change in the rate of tax applicable to trusts (RAT), as well as consultation on modernising the tax system for trusts. Four separate discussion papers were issued in December 2003, and these were followed by a series of meetings with representative bodies and interested parties in January and February 2004.

In the Budget 2004, the Chancellor announced certain measures to be introduced from 2004 and 2005 as well as the main features of the proposed new system, most of which has been subject to further consultation. Certain measures were introduced in Finance Act 2005 (most notably, a new income and capital gains tax regime for trusts with vulnerable beneficiaries) and a further consultation document was issued in August 2005.

On 31 January 2006, HMRC issued draft clauses to amend certain provisions of TCGA 1992, ICTA 1988 and ITTOIA 2005, which have to do with the taxation of settlements, and which came into effect in 2006 and 2007.

2005 also saw the introduction of a tax on pre-owned assets. The tax was introduced by Schedule 15 of the Finance Act 2004 to impose an annual income tax charge from 6 April 2005 on the deemed value of benefits retained by UK taxpayers who had successfully circumvented the inheritance tax (IHT) gifts with reservation rules.

On 22 March 2006, without any prior warning and no prior consultation, came the bombshell in the form of Budget Note 25 (BN25) issued by HMRC, even though none of this was mentioned by the Chancellor in his Budget speech.

Although BN25 called the exercise the “alignment” of IHT treatment for trusts, what was really being proposed was a near total elimination of the pre-Budget rules with immediate effect and the application of the discretionary trust regime for IHT to all trusts except absolute trusts and certain trusts for vulnerable beneficiaries.

A storm of protest followed from practitioners and professional bodies such the Society of Trust and Estate Practitioners and the Law Society. Further efforts to revise if not abandon the proposals published in the 2006 Finance Bill continued throughout the Parliamentary stages.

In some respects, it was clear that the hasty drafting of the 2006 Finance Bill did not follow the announcement made by HMRC, especially as far as life policy trusts were concerned, where HMRC insisted in a number of publications that such trusts were not going to be affected by the changes but the Finance Bill did not include any provisions to protect such trusts.

The final shape of the provisions of Finance Act 2006 turned out considerably more agreeable to practitioners and taxpayers alike following the strong representations and lobbying from professions. Nevertheless, the IHT reform of 2006 is bound to go down in history as one of the biggest overhauls of the tax system in the last 20 or 30 years. This is especially so given that the reform also covered substantial areas of the income tax and capital gains tax (CGT) treatment of trusts.

The fundamental overhaul of CGT in 2008 with the introduction of the flat 18% rate and the abolition of CGT taper relief had the effect of reversing some of the 2006 changes and repealing the settlor-interested provisions.

The next bombshell was presented in the Pre-Budget Report in November 2008 when a new higher rate of income tax (the "additional rate") was announced for those earning in excess of £150,000. It transpired that the new rates (of 42.5% and 50% instead of 32.5 and 40%) would apply to all trusts regardless of the level of income. Initially, the new rates were to apply from 2011 but following an announcement in the Budget 2009 on 22 April 2009, these higher rates applied from 6 April 2010 – 5 April 2013. From 6 April 2013, the additional rates decreased to 37.5% and 45%.

The Pre-Budget Report on 9 December 2009 announced two further specific anti-avoidance measures in the IHT area - targeted at schemes which sought to avoid an IHT charge when putting property into trust - as well as stating that the Government was looking at "wider solutions to the problem of trusts being used to avoid IHT charges". But, whilst the last Labour Budget, in March 2010, included little more for trustees except with regard to employee benefit trusts (EBTs), where proposals to introduce anti-avoidance measures from April 2011 were announced, the first Con-Lib Budget in June 2010 had the next instalment of bad news for trustees, namely the increase in the CGT rate for trustees from 18% to 28% for disposals after 22 June 2010.

Since then, there have been a few minor tweaks – most notably an alignment of the rules on the application of capital and income under trusts for the disabled and vulnerable; and the provisions of the Perpetuities and Accumulations Act 2009 – but nothing as significant as the wholescale changes seen in the period 2003-2008.

In addition to the above, the Disclosure of Tax Avoidance Schemes (DOTAS) regime was extended with effect from 6 April 2011 to include new or innovative IHT arrangements which aim to seek to avoid or reduce the IHT entry charge when transferring property into trust; and the General Anti-Abuse Rule (GAAR), which came into force on 17 July 2013, and applies to 'abusive tax arrangements' across the taxes.

Finally, it should be noted that at Summer Budget 2015, it was announced that, from 6 April 2016, the existing dividend tax credit of 10% was abolished in favour of a new 'dividend allowance' of £5,000 for all individual taxpayers (this was reduced to £2,000 for tax year 2018/19, further reduced to 1,000 for tax year 2023/24 and to £500 from 6 April 2024) – however there is no dividend allowance for trusts.

The dividend rate for trusts matches the additional rate for individual taxpayers and was 38.1% for 2016/17 and until 5 April 2022. From 6 April 2022 the rate is 39.35%.

Background to the reform

The reasoning behind the changes as stated at the time was that the Government wanted a tax system for trusts that did not provide artificial incentives for individuals to set up a trust but, equally, avoided artificial obstacles to using trusts where they would bring significant non-tax benefits.

The Government did not want a system that enables people to use trusts to avoid tax but, equally, as far as possible, it did not want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as under the laws of intestacy. Neither did it want to penalise beneficiaries where a trust exists to protect the vulnerable, such as a disabled person. In addition, the Government wanted to reduce the administration and compliance burdens of trusts, particularly small trusts, and believed that any new measures should...

- Be fair.
- Support the competitiveness of the UK
- Be clear and easy to operate.

As far as possible the Government's aim was to tax the person benefiting from the trust where that person can be identified. So, its objectives were that...

- The tax system should be as simple and easy to understand as possible.
- Complying with tax obligations should be straightforward.
- Where a beneficiary receives income or benefits from a trust they should be taxed as if they received them direct.
- Where a settlor retains an "interest" in a trust they should be treated as if they still owned the assets.
- Where the income or assets cannot readily be identified with settlors or beneficiaries, tax should be levied on the trustees.
- Trustees with little income and no capital gains should not have to complete self assessment returns every year.
- Trusts set up to protect the "vulnerable" (i.e. orphaned minor children or the disabled) should receive special treatment.
- Anti-avoidance legislation should be used against those who use trusts to avoid tax.
- Taking all of these objectives into account, the three areas in which changes have been introduced as part of a modernised tax system are...

i) the definitions in the tax legislation;

ii) the income tax treatment of trusts;

iii) the CGT treatment of trusts.

It has to be said that, given the substantial increases in the tax rates payable by trustees since April 2004 (when the rate applicable to trusts was just 34%), the view of many trust practitioners is that the Government went beyond their original objective of fairness in that trustees are now suffering from what some see as punitive rates in comparison with the tax rates borne by corporations as well as individuals.

The rate applicable to trusts from 6 April 2004

- The rate applicable to trusts (RAT) increased from 34% to 40% and the corresponding dividend trust rate from 25% to 32.5% with effect from 6 April 2004.
- With effect from 6 April 2004 section 677 of the ICTA 1988 (now incorporated in Chapter 5 Part 5 ITTOIA 2005), which charges tax on loans or other capital sums made by trustees to the settlor of a trust (that is the person who put funds into the trust) or their spouse/civil partner, was amended to ensure that the settlor is not given credit for more tax than the trustees have actually paid.

The increase in the RAT, now known as the “trust rate”, eliminated any tax advantage in trustees of discretionary trusts and accumulation and maintenance trusts accumulating income in the trust.

Before 6 April 2004 any income accumulated in a discretionary (usually accumulation and maintenance) trust, even if the beneficiaries were minor unmarried children of the settlor, would suffer a maximum 34%/25% tax charge, as appropriate, depending on the type of income.

As such it provided a possible 6% income tax saving where the settlor was a higher rate taxpayer, as the parental settlor anti-avoidance provisions did not apply unless the child was either entitled to income or the income was distributed. This type of planning has not worked since 6 April 2004.

The increase in trust rates meant that non-income producing assets, such as life assurance investment bonds, became even more popular as trustee investments.

Other measures introduced in 2005

Standard rate band (effective as a result of Finance Act 2005 with effect from 6 April 2005)

2005 saw the introduction of a “standard” rate band applying to the first slice of income for all trusts liable at the special trust rates, that is, discretionary trusts and accumulation and maintenance trusts. This band was initially set at £500 and increased to £1,000 with effect from 6 April 2006. The standard rate band was abolished with effect from 6 April 2024 – please see later.

Trusts which received income up to the standard rate band either net of tax or with an associated tax credit had no further tax to pay on that income. Those which received gross income within the standard rate band had to pay tax at the basic rate depending on the nature of the income. Trust income in excess of £1,000 was taxed at the usual rates applicable to trusts.

The standard rate band was apportioned between all the settlements made by the same settlor, subject to a minimum of £200 per trust. This was implemented in Finance Act 2006 with effect from 6 April 2006.

The introduction of the standard rate band was meant to take around 30,000 of the smallest trusts out of the full self-assessment system. This was a very welcome measure, especially given the increase of the standard rate band to £1,000 in 2006. The subsequent anti-fragmentation provisions, which came into effect from 6 April 2006, made the use of the standard rate band less attractive. Nevertheless, it may have served to encourage individuals to create trusts, especially for the benefit of minor children, where the reporting requirements and the additional tax in the case of discretionary trusts and accumulation and maintenance trusts had until then been an obstacle to such planning.

Following the changes in 2023, with the standard rate band being abolished from 6 April 2024, the Government made a concession to certain "small" trusts, announcing that trusts with total income of less than £500 in a tax year will not have to pay any income tax at all (again subject to the £500 limit being scaled down if the settlor has created more than one trust).

Trusts for vulnerable beneficiaries (effective as a result of Finance Act 2005 with effect from 6 April 2004)
Finance Act 2004 introduced a new tax regime for trusts for the most vulnerable, allowing these trusts to be taxed on the basis of the vulnerable beneficiary's individual circumstances for both income tax and CGT provided the trustees and the beneficiary/guardian of the beneficiary, depending on the circumstances, makes an appropriate election.

These measures effectively enable the trustees to use the individual beneficiary's personal allowances, 10% and basic rate bands, rather than being taxed at the special trust rates where the various qualifying conditions are met. For CGT purposes, the beneficiary's personal annual exemption is available.

The vulnerable beneficiaries covered by these provisions include disabled persons and minor children with at least one deceased parent.

Further measures on income tax and CGT introduced in Finance Act 2006
The following important changes, relating to the taxation of settlements, were made to the Taxation of Chargeable Gains Act 1992 (TCGA), ICTA 1988 and ITTOIA 2005 by Finance Act 2006...

1. **Definition of settlor and settlement**

It has been one of the key aims from the beginning of the reform to provide a common definition of "settlor" as, before 6 April 2006, different definitions applied for the purposes of the different taxes. There is also a definition of "settled property" but not a statutory definition of "settlement" which continues to be based on case law.

HMRC opted for the previous CGT definition of "settlor" to apply for most purposes of both income tax and CGT.

The common definition of settlor is 'the person, or any of the persons, who has made the settlement' and includes a person who makes or enters into a settlement directly or indirectly. This includes a person who provides, directly or indirectly, property for the purposes of the settlement. Also, where the settled property, or property derived from it, is property which a person was competent to dispose of immediately before their death, that person will be treated as the settlor.

If one person (A) makes or enters into a settlement in accordance with reciprocal arrangements with another person (B), then B will be treated as the settlor. Where assets are transferred between two settlements, the settlor of the transferor settlement will be treated as the settlor of the transferee settlement (except in certain specified circumstances, one of which is where the transfer happens on the exercise of a general power of appointment).

There are also common rules setting out who is to be treated as the settlor in relation to post death deeds of variation.

Although there is no new statutory definition of settlement, the current CGT definition of settled property now also applies for income tax purposes. This definition covers all property held in trust other than as a nominee or under a bare trust (where the beneficiaries are absolutely entitled to the assets).

The wide definition of settlement contained in the income tax anti-avoidance provisions continues to apply only for those purposes.

2. **New definition of settlor-interested trust**

One of the most significant changes introduced in 2006 was the amendment to the definition of settlor-interested trusts for the purposes of taxing the capital gains of a trust on the settlor (section 77 TCGA).

Although HMRC had indicated that this was to bring the CGT treatment more closely into line with the income tax treatment in fact the CGT definition in 2006 was much wider than that for income tax. A settlement became settlor-interested for CGT purposes if the settled property "is, will or **may** become, payable to, or applicable for the benefit of the settlor's "dependent child" (i.e. a minor unmarried child who is not in a civil partnership*).

For income tax purposes, a settlor is taxable on the income of the settlement in these circumstances only when such a child either is entitled to or actually receives a benefit. The 2006 definition applied to settlements, whenever created, from 6 April 2006 and, so, many settlements which were previously not settlor-interested

for CGT purposes automatically became so on 6 April 2006 as a result of this provision.

The trusts caught under these provisions included, for example, accumulation and maintenance trusts for the settlor's children and discretionary trusts under which the settlor's children could benefit. Prior to 6 April 2006 such trusts were only treated as settlor-interested if the settlor or the settlor's spouse/civil partner could benefit and income was taxed on the settlor only if it was actually paid out to the beneficiary.

One of the consequences of this change to the definition of settlor-interested settlements is that hold-over relief, on a transfer of business assets or a transfer which gives rise to an immediate IHT charge (e.g. to a discretionary trust), is no longer available where the settlor transfers assets into a settlement under which their minor unmarried children, who are not in a civil partnership*, are potential beneficiaries. Prior to 6 April 2006, in such circumstances, a hold-over claim could have been made which had the effect of deferring any CGT charge.

As it turned out, the above provisions, apart from their application for the purpose of the hold-over relief, remained in force only for two tax years, as they became redundant following the CGT reform in 2008 – please see below.

3. **Income tax treatment of settlor-interested trusts**

There is a provision, effective from 6 April 2006, whereby the income of settlor-interested settlements is to be treated as though it had arisen directly to the settlor, i.e. retaining its form, e.g. income from a trade or dividends, thus removing the anomalies in the rates of tax that previously applied in such circumstances.

One of the unexpected changes introduced by Finance Act 2006 was the new provision under which trustees of settlor-interested trusts were no longer excluded from the charge to tax at the higher rates. Prior to 6 April 2006, discretionary trusts which were settlor-interested trusts by virtue of the settlor or settlor's spouse/civil partner being one of the beneficiaries, were excluded from the special trust rate on the grounds that the settlor was assessed to income tax on all trust income.

With effect from 6 April 2006, this exclusion no longer applies so that the trustees of such trusts still have to do tax returns and pay income tax at the appropriate rates: currently 39.35% on dividends and 45% on other income (subject to any appropriate tax credit up to 5 April 2016), even though the income is treated as income of the settlor and the settlor is assessed to tax on that income. HMRC has confirmed that where the settlor is not an additional rate taxpayer, they will be able to recover from HMRC any tax overpaid by the trustees and an appropriate provision to give this effect was included in the Finance Act 2010.

Nevertheless, the change imposed a considerably greater administrative burden on the trustees. This provision has become more important from 6 April 2010 (as even higher rate taxpaying settlors became entitled to a refund if they were not 45% taxpayers) and then improved again from 6 April 2016, with the introduction of the dividend allowance and personal savings allowance (PSA) for individual taxpayers

in 2016 as, while the trustees are not entitled to the PSA or dividend allowance, the settlor is.

A further measure that has been introduced is designed to give legal effect to the existing practice of not taxing beneficiaries who receive discretionary income payments from the trustees of settlor-interested trusts (i.e. where the settlor is already taxed on those payments).

4. **Trustees' residence**

There is a common test, for both income tax and CGT purposes, to determine whether or not the trustees of a settlement are resident in the United Kingdom. This is based on the original income tax test.

This uses the residence status of the trustees, and takes into account the residence and domicile status of the settlor at the relevant time where there is a mixture of UK resident and non-UK resident trustees. The common test applies for the purpose of determining the residence status of trustees from 6 April 2007, **whenever the trust was created**. This gives trustees time to rearrange their affairs to avoid any unintentional change of residence status due to the introduction of the common test.

5. **Sub-funds**

There is a provision, from 6 April 2006, for the trustees of a settlement to elect that a sub-fund of the settlement be treated as a separate settlement for income and CGT purposes in certain circumstances.

Where a settlement has been divided into one or more sub-funds which are administered by either the same, or different, trustees for different beneficiaries, administrative problems often arise because the main settlement and any sub-funds are treated as a single settlement for CGT purposes.

The provision allows the trustees of the principal settlement to elect that a sub-fund be treated as a separate settlement for tax purposes. In order to be able to make the election, some assets must remain in the principal settlement, the sub-fund must not contain jointly owned assets and there must not be any beneficiaries who could benefit under both the sub-fund and the principal settlement. **The trustees' annual CGT exemption will be apportioned between the principal settlement and the sub-funds.**

Making the election will give rise to a disposal for CGT purposes, by the trustees of the principal settlement, of the property in the sub-fund. This means that the trustees would be in the same position as trustees who had used their powers to transfer property out of the principal settlement into a new settlement. Once made the sub-fund election cannot be revoked. The availability of this election will only be of real benefit to trustees of settlements who lack the powers necessary to settle property on new trusts..

6. **Further measures dealing with the standard rate and trusts for vulnerable beneficiaries**

Anti-avoidance provisions were introduced just one year after the introduction of the standard rate of income tax to stop a settlor taking advantage of the new standard rate band by setting up numerous trusts each having a separate standard rate band. However, simultaneously, the standard rate band was increased to £1,000 with effect from 5 April 2006. The standard rate band has, from 6 April 2006 until 5 April 2024, been split between all settlements created by one settlor, subject to a minimum of £200.

There are a number of consequential amendments which deal with trusts for disabled persons and relevant minors, i.e. trusts with vulnerable beneficiaries, especially in relation to the vulnerable person election and sub-funds election.

7. **Other measures**

There is a provision for the trustees of a settlement to be treated as a single person for income tax purposes as they are already for CGT purposes;

There is also a common charging mechanism for various types of receipt, which are capital receipts for trust purposes, but are treated as income for tax purposes. An example of this is a chargeable event gain under a life assurance policy.

8. **Trust management expenses**

HMRC published guidance on the deductibility of trust management expenses (TMEs) in 2006 and it was at that time viewed as controversial by the trust industry. In particular, HMRC took the stance that trustee fees could not be deducted from income at all because they are not an 'expense of the trustees'. Accordingly, all fees were properly payable from capital.

Despite the HMRC guidance, in practice, many continued to deduct trustee fees from income.

The issue was resolved by the judgment in *Peter Clay*. (*HMRC v Trustees of the Peter Clay discretionary trust* (2009) WTLR 247 STC 469) and, in April 2011, HMRC published its new (substantially rewritten) guidance to reflect the *Peter Clay* decision. The complete set of rules are now contained in HMRC's Manual: TSEM (TSEM8000 to 8790) but a more useful guidance for trustees can be found in the Help sheet 392 - Trusts Management Expenses.

Aligning the IHT tax treatment for trusts

As indicated in the introduction, this was one of the biggest IHT reforms for 20 years. The following are the key areas dealt with in Schedule 20 Finance Act 2006.

Section 156 and Schedule 20 Finance Act 2006 introduced new IHT rules for assets held in trust. These were first announced in the Budget on 22 March 2006 and originally contained in the Finance (No. 2) Bill 2006. Substantial amendments were made to the original provisions as presented in the Budget and in the Finance Bill.

The following is a brief summary of the key provisions as set out in Schedule 20.

Part 1 – "Trusts for Bereaved Minors", "age 18-to-25 trusts" and "accumulation and maintenance" trusts

This covers the new types of trust introduced by the Finance Act 2006. Trusts for Bereaved Minors (TBMs) and age 18-to-25 trusts 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 intestacy of a parent will be TBMs while 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 new treatment for age 18-to-25 trusts also applies to pre-22 March 2006 accumulation and maintenance 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 at the latest.

Part 2 – Interests in possession: when settled property is part of the beneficiary's estate

This part created the concept of the immediate post-death interest (IPDI) and transitional serial interest (TSI) as well as the disabled person's interest (DPI). Only entitlements to these interests are now treated in the same way as pre-Budget 2006 interests in possession under section 49 IHTA 1984, with the effect that the value of trust assets will be aggregated with the estate of the person with the relevant interest and the settled property will not be subject to the discretionary trust regime.

An IPDI is an interest in possession regardless of in whose favour it is vested (i.e. not just the spouse/civil partner of the testator) but it can only be created under a Will or intestacy.

A TSI is an interest to which a person becomes entitled during the transitional period between 22 March 2006 and 5 October 2008. The original 5 April 2008 deadline for interest in possession trusts was extended to 5 October 2008 in the Budget 2008.

TSIs are treated in the same way as pre-Budget 2006 interests in possession and continue to be subject to the current rules until either someone becomes absolutely entitled to the settled property or the interest is changed. If the interest is changed but the property remains subject to trust (i.e. somebody does not become absolutely entitled as a result of the appointment) the trust will become subject to the new fully discretionary trust rules.

There is an exemption from the rules to allow a spouse/civil partner exemption to apply or a TSI to be terminated in favour of the surviving spouse/civil partner of the previous beneficiary and, of course, as is stated above, appointments (only one per trust) up to 5 October 2008 were "inoffensive".

Pre-Budget 2006 treatment also continues to apply to s89 IHTA trusts for disabled persons (i.e. where the disabled person has a 'deemed' interest in possession) regardless of when the trust was created. The provisions were also extended to 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) as well as to trusts under which the disabled person has an actual interest in possession.

More favourable rules apply to pre-Budget 2006 life policy trusts.

Part 3 – Related amendments to IHT Act 1984
Of most importance in this part are the paragraphs dealing with potentially exempt transfers (PETs) and life assurance policies.

Paragraph 9 provides that section 3A of IHT Act 1984 is amended to provide that, with effect from 22 March 2006, PETs are only those transfers that constitute a gift to another individual (this will include a gift to a bare trust), a gift to a disabled trust or a gift into a bereaved minor's trust on the coming to an end of an IPDI.

Paragraph 11 offers transitional provisions for life assurance policies entered into before 22 March 2006 which basically provide that where a life policy has been settled on either interest in possession or accumulation and maintenance trusts before 22 March 2006, where the premiums continue to be paid on or after that date the whole of the policy qualifies for transitional protection as an asset of a pre-Budget 2006 trust. This also applies if increased premiums are paid under the policy in accordance with the policy conditions. It also continues to apply where an interest in possession under a pre-Budget 2006 policy is terminated on the death of the original beneficiary.

In other cases, the termination of an interest in possession will be treated as a chargeable transfer of value. There is an exception where the property reverts to the settlor or passes to the settlor's spouse or civil partner on the death of the previous beneficiary.

The remaining paragraphs of this part contain exemptions from the IHT charges for TBMs, age 18-to-25 trusts, disabled trusts, etc.

Part 4 – Property subject to a reservation
This amends section 102 Finance Act 1986 (gifts with reservation) to provide that when an individual's interest in possession is terminated (wholly or in part) during their lifetime but the individual remains as one of the potential beneficiaries under the trust, the coming to an end of the interest in possession will be treated as a disposition by way of gift with the effect that such a disposition will become a gift with reservation of benefit. This was a change to the pre-Budget rules announced in the Budget 2006.

Reform of CGT – Finance Act 2008
Finance Act 2008 introduced a fundamental change to the CGT regime affecting all taxpayers, including trustees.

This included the following measures relevant to trusts…

- New uniform rate of 18% for all taxpayers (excluding corporations).
- Abolition of CGT taper relief.
- Abolition of settlor-interested provisions for CGT only (except for the purpose of hold-over relief).

Changes to income tax rates for trusts from 6 April 2010

- With effect from 6 April 2010, the 40% trust rate was increased to 50% (with the dividend rate increasing to 42.5% from 32.5%). This was a significant increase for trustees and, unlike the 50%/ 42.5% rates for individuals, the higher trust rate was not restricted to income that exceeds £150,000.
- The 2013 Budget introduced a reduction in the trust rates from 6 April 2013 to 45%/37.5%.
- From 6 April 2016/17, the dividend rate for trusts increased again - to 38.1% in conjunction with the introduction of a new 'dividend allowance' of £5,000 for all individual taxpayers taking effect from the same date. The dividend allowance was reduced to £2,000 for tax year 2018/19, further reduced to £1,000 for tax year 2023/24 and to £500 from 6 April 2024.
- For 2017/18 and until 5 April 2022 the dividend rate for trusts remained at 38.1%. From 6 April 2022 the rate is 39.35%.

Measures included in Finance Act 2010

Provisions to prevent avoidance of IHT in two particular ways were introduced in the Finance Act 2010.

Two particular types of scheme were affected...

- Prior to Finance Act 2010, if a person made a gift into a settlement under which they retained a future reversionary interest, that interest would have a value for IHT purposes. This would reduce the transfer of value (the loss to their estate) making it easier to keep any chargeable lifetime transfer within the settlor´s nil rate band. If the settlor subsequently gifted the reversionary interest, that was a PET. This would allow the property to be gifted with only a small amount consisting of a chargeable lifetime transfer.

  Alternatively, if the settlor´s interest vested and that interest then constituted an interest in possession, under the post Finance Act 2006 rules that interest would have no value for IHT purposes.

  This loophole was addressed by the Finance Act 2010, which provided that where a person transfers property into a trust in which they (or their spouse/civil partner) retain a future interest there will be a chargeable transfer for IHT purposes when the future interest comes to an end and the person becomes entitled to an actual interest under the trust. If that future

interest is given away before the person becomes entitled to an actual interest, it may be immediately chargeable to IHT.

- A non-IPDI interest in possession had no value for IHT purposes under the 2006 legislation. This means that if a person used cash to purchase an interest in possession under a trust (which is, say, for the benefit of their family) for full market value they will swap a valuable asset for an asset that has no value for IHT purposes.

  The Finance Act 2010 provided that such an interest will be treated as part of the purchaser´s estate for IHT purposes and if the interest comes to an end during the purchaser´s lifetime, there may be an immediate charge to IHT.

Further reform in 2010 and beyond

Increase in the CGT rate

The first Budget of the Con-Lib Government increased the 18% rate to 28% for trustee disposals occurring after 22 June 2010. The 28% rate also applied to higher rate individual taxpayers and personal representatives.

From 6 April 2016, the higher rate of CGT applicable to trustees, personal representatives and higher rate taxpayers reduced to 20%, although the higher rate of 28% still applied for carried interest and, until 5 April 2024, for residential property which is not occupied as a beneficiary's main residence. From 6 April 2024, the 28% rate for disposals of residential property was reduced to 24%.

Settlor-interested trusts

Settlors of settlor-interested trusts may receive repayments of tax on trust income if they are liable to income tax at less than 45%.

Provisions were included in Finance Act 2010 amending section 646 ITTOIA 2005 to require such settlors to pay such repayments of tax back to the trustees. There are no IHT implications of such repayments back to the trust by such settlors.

Alignment of rules on application of capital and income for trusts for the disabled and vulnerable

Prior to 8 April 2013 there was a discrepancy between the IHT position and the post-2005 income and capital gains tax rules concerning the application of capital and income under a trust for a disabled or vulnerable beneficiary during the beneficiary's lifetime.

While the IHT rules stated that at least half of the settled property applied during the disabled person's lifetime had to be applied for the benefit of the disabled person in order to qualify for preferential IHT treatment; a qualifying vulnerable beneficiary trust was defined as one which allows **no part** of the settled property to be used for the benefit of anyone other than the vulnerable person. There were further discrepancies between the meaning of a disabled trust for IHT and CGT purposes.

These discrepancies were eradicated by Finance Act 2013 which aligned, across the taxes, the rules on how much capital and income can be applied by the trustees of a vulnerable beneficiary trust for the benefit of someone other than the disabled or vulnerable person during the vulnerable person's lifetime. The new rules are as follows...

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.

The new common rule is subject to a proviso which allows the trustees to apply 'modest amounts' of capital or income for the benefit of persons other than the vulnerable person.

The amount has initially been set at the lower of £3,000 or 3% of the trust fund in any tax year in recognition of the fact that there may be occasions when a payment to another person – for example a member of the vulnerable person's family who is a carer – may be justified.

Anti-avoidance

As mentioned in the Introduction above, DOTAS regime was extended, with effect from 6 April 2011, to include IHT arrangements where the aim of those arrangements is to seek to avoid or reduce the IHT entry charge when transferring property into trust.

In order for an IHT scheme to be disclosable...

- the arrangements must result in property becoming 'relevant property' as defined under s.58(1) of the Inheritance Tax Act 1984;
- the main benefit of the arrangements must be the reduction, deferral or avoidance of the IHT entry charge.

Under these rules, schemes which are the same or substantially the same as arrangements made available before 6 April 2011 were exempted from disclosure.

However, revised DOTAS Regulations in relation to schemes established to avoid IHT were set out in Statutory Instrument 2017 No. 1172 entitled 'The Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2017'. These rules came into force on 1 April 2018 and adopt a broader approach to what was previously proposed. In particular, there is now no specific exclusion from DOTAS for loan trusts, discounted gift trusts and reversionary interest trusts unless a scheme was in force before 1 April 2018 and acceptable under established HMRC practice.

In addition to the DOTAS regime, a General Anti-Abuse Rule (GAAR) was introduced in the UK, as part of the Government's commitment to combat tax avoidance and evasion. The GAAR came into effect on 17 July 2013 and applies across the taxes to 'abusive tax arrangements' entered into on or after that date.

The legislation is supplemented by detailed guidance that was produced by HMRC and contains a number of examples of situations where the GAAR would and would not apply. Notably, arrangements do not come within the GAAR if either the relevant tax rules were intended to secure that outcome or they are in accordance with accepted practice and HMRC has indicated its acceptance of that practice.

Perpetuities and Accumulations Act 2009
The Perpetuities and Accumulations Act came into force on 6 April 2010. The main effects of the Act are that...

- For settlements made and Wills executed on or after 6 April 2010 the perpetuity period will be 125 years;
- An accumulation period in a private trust may now extend for the whole of the perpetuity period and is not limited to 21 years;
- Where an existing settlement has a perpetuity period which is governed by a life (or lives) in being then the trustees have power to adopt a perpetuity period of 100 where it is 'difficult or not reasonably practicable' to ascertain whether the lives have ended

Trusts (Capital and Income) Act 2013
The Trusts (Capital and Income) Act received Royal Assent on 31 January 2013. The two main reforms affecting private non-charitable trusts are...

- disapplication, for new trusts, of certain technical rules requiring the apportionment of receipts and outgoings between income and capital, so that they only apply where the creator of the trust has specifically incorporated them;
- rationalisation of the trust law classification of receipts from tax-exempt corporate demergers by ensuring that all such receipts are treated as capital, together with a power for trustees to redress an income beneficiary's position in appropriate circumstances.

The above provisions came into force on 1 October 2013.

Taxation of IHT exit and periodic charges for discretionary trusts
The calculation of periodic and exit charges can be complicated and it is not uncommon for the professional costs incurred in calculating the tax liability to exceed the amount of tax at stake. HMRC recognised this and, in the 2012 Budget, it was announced that the Government would consult on simplifying the calculation of the IHT exit and periodic charges for trusts falling within the relevant property regime.

It was initially intended for legislation to be included in Finance Bill 2013, with the aim to simplify the calculations by...

- Ignoring the settlor's previous lifetime transfers when determining the available nil-rate band for the purposes of calculating the hypothetical transfer on exit charges and ten-year anniversary charges.
- Ignoring non-relevant property for the purposes of the calculation of periodic and exit charges.
- Spitting the nil-rate band across the number of relevant property settlements which the settlor has made.
- Applying a simple rate of 6% to the chargeable transfer for the purposes of periodic and exit charges, rather than requiring lengthy calculations of an effective rate.

However, following extensive consultation, these proposals were withdrawn in favour of the introduction of a specific anti-avoidance rule that targets a common Will planning technique which exploits the technicalities of the 'added property' rules. The only 'simplification' measure that survived the consultation process came in the form of legislation (included in Finance Act 2015) which removed the requirement to include non-relevant property in the calculation of the rate of charge on a ten-year anniversary for charges arising on or after 6 April 2015.

As part of the consultation process, HMRC also proposed an alignment of filing and payment dates for IHT as well as clarification on the treatment of accumulated income and, to this end, legislation included in Finance Act 2014 amended section 216(6) IHTA1984 (time for delivery of accounts) and section 226 IHTA 1984 (payment of tax) so that trustees of relevant property settlements must deliver the IHT account six months after the end of the month in which the chargeable event occurs and pay the tax by the end of the same period. This ensures that returns and payments continue to be submitted evenly throughout the year.

Finance Act 2014 also introduced a new section 64(1A) IHTA 1984 which treats income that has remained undistributed for more than five years at the date of the ten-year anniversary as if it was part of the trust capital for the purposes of the ten-year anniversary charge. To avoid the need for trustees to keep very detailed records, tax would be charged on the ten-year anniversary at the full rate on any such undistributed income without any proportionate reduction to reflect the period during which the income has been retained.

These rules have effect for tax charges arising on or after 6 April 2014.

Inheritance and Trustees Powers Act 2014

The Inheritance and Trustees Powers Bill was introduced into the House of Lords on 30 July 2013 and implemented many of the recommendations contained in a report published by the Law Commission on 14 December 2011.

In May 2014, the Inheritance and Trustees' Powers Act 2014 received Royal Assent. The Act contains important revisions to the intestacy rules in England and Wales which took effect from 1 October 2014.

The Act made certain changes to the rules on intestacy and for reasonable provision out of a deceased's estate to 'reflect modern social expectations' and included further trust reform in the shape of an extension to the trustees' powers of advancement and maintenance.

- Power to apply income – s.31 Trustee Act 1925

Clause 8 of the Act amended the statutory power of trustees under s.31 Trustee Act 1925 to use the income of the trust fund for the maintenance, education or benefit of a beneficiary who is under 18 and has an interest in those funds. Prior to the Act, trustees could only apply such income if it was reasonable to do so in the circumstances. The Act removed that objective test, so that any decision to apply the income of a trust fund is now at the trustees' discretion. The proviso in s.31(1) of the Trustee Act 1925, which states that the trustees must have regard to any other income which may be available for the minor's maintenance, is also removed.

- Power to advance capital – s.32 Trustee Act 1925

Clause 9 amended the statutory power of advancement to apply capital of the trust fund to a beneficiary under s.32 Trustee Act 1925. Prior to the Act, trustees could only apply half of a beneficiary's prospective share. The Act removed that restriction, so that trustees are free to apply the whole of a beneficiary's prospective share of capital. This reflects the position commonly adopted by solicitors and other Will drafters.

Trust registration service
In April 2017, Form 41G (Trust) (used to notify HMRC of trusts' creation) was withdrawn and replaced with the online Trust Registration Service (TRS) launched in June 2017.

2018 consultation on taxation of trusts
At the November 2017 Autumn Budget, the Government announced that it was going to launch a consultation in 2018 in relation to the taxation of trusts and, in particular, how the taxation of trusts might be made simpler, fairer and more transparent. The consultation ran from November 2018 until 28 February 2019.

The Government did not make any specific proposals for reform of the taxation of trusts, but wanted to consider the views and evidence presented in response to the consultation and was going to then weigh up the options for reforms accordingly.

Amongst the options discussed in the consultation document was the possibility of targeted reform to the IHT regime as it applies to trusts, and the simplification of vulnerable beneficiary trusts, including their interaction with age 18-to-25 trusts.

In March 2021, the Government published a Summary of responses to the Consultation. The conclusion was that the responses did not indicate a desire for comprehensive reform of trusts at that stage. The Government said it would keep the issues raised under review to ensure that its long-term approach to the taxation of trusts met its objectives, and, in the shorter term, that it would continue to review specific areas of trust taxation on a case-by-case basis, with responses relating to those areas forming part of the consideration.

2023/24 changes to the taxation of trusts

In the Spring Budget in 2023 the Government announced its intention to legislate a package of simplification reforms for trusts. These reforms are now in s 29 and Sch 2 Part 2 of the Finance (No2) Act 2023. These provisions came into effect from 6 April 2024, and...

- provide that trusts and estates with income up to £500 do not pay tax on that income as it arises. Where a settlor has made other trusts, the amount is the higher of £100 or £500 divided by the total number of existing trusts (subject to some exceptions);
- remove the default basic rate and dividend ordinary rate of tax that applies to the first £1,000 slice of discretionary trust income (i.e. the standard rate band);
- provide that beneficiaries of UK estates do not pay tax on income distributed to them that is within the £500 limit for the personal representatives.

*Please note, in relation to any references to minor unmarried children/minor children not in a civil partnership, in this guide, that the Marriage and Civil Partnership (Minimum Age) Act 2022, which came into force on 27 February 2023, means that 16 and 17 year-olds will no longer be allowed to marry or enter a civil partnership, even if they have parental consent.

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