

ACTON FINANCIAL MANAGEMENT – TRUST INFORMATION SHEET

Trusts. What they are and how they are created

What is a 'trust'?

A trust is an obligation binding a person (which can be an individual or a company) called a 'trustee' to deal with 'property' in a particular way, for the benefit of one or more 'beneficiaries'.

What is a 'trustee'?

Trustees are the legal owners of the trust property. They are legally bound to look after the property of the trust in a particular way and for a particular purpose. Trustees administer the trust and in certain circumstances make decisions about how the property in the trust is to be used.

The trust can continue even though the trustees might change, but there must normally be at least one trustee.

What is 'property'?

The property of a trust can include

- money
- investments
- land or buildings
- other assets, such as paintings.

The cash and investments held in the trust are also called the 'capital' or 'fund' of the trust. This capital (or fund) may produce income, such as interest or dividends. The land and buildings may produce rental income. The way income is taxed depends on the type of trust.

What is a 'beneficiary'?

A beneficiary is anyone who benefits from the property held in the trust. There can be one or more beneficiaries, such as a whole family or a class of people, and each may benefit from the trust in a different way.

For example, a beneficiary may benefit from

- the income only, or
- the capital only, or
- both the income and capital of the trust.

What is a 'settlor'?

A settlor is a person who has put property into the trust. Property is normally put into the trust when it is created, but it can also be added at a later date.

Is a settlement the same as a trust?

The words 'settlement' and 'trust' are sometimes used in place of each other, and to describe the same thing. For tax purposes, the term 'settlement' can have a wider meaning and can include various other arrangements or agreements. This only deals with trusts, and settlements that are trusts.

How is a trust created?

Normally a trust is created by a deed. A settlor might ask a professional adviser to draw up a trust deed, which then sets out the terms of the trust.

A trust can be created under the terms of a will, when someone leaves instructions that when he or she dies some or all of the estate is to be placed in trust. A trust can also occur if a person dies without leaving a will.

Sometimes the Courts will create a trust, for example, when deciding how to deal with property for the benefit of a child or an incapacitated person who cannot manage his or her own affairs.

I am a settlor. What do I have to do when a trust is created?

Trust law and the taxation of trusts can be complicated. If you want to create a trust you should seek professional advice. He or she can draw up the trust deed for you, and give advice on other legal matters relating to trusts.

You should tell your Inland Revenue Office if you have put property into a trust.

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I am a trustee. What do I have to do when a trust is created?

If you expect the trust to be liable to tax on income or gains, you should inform us as soon as the trust is created. You can do this by completing an Inland Revenue form Inland Revenue form 41G which is available from any Inland Revenue Enquiry Centre or Tax Office. Send the completed form to the Inland Revenue Trusts office that deals with your area.

Please **do not** send a copy of the trust deed. The Inland Revenue Trusts office will ask for it if they need to see it.

What are my responsibilities as a trustee?

Your responsibilities depend on the type of trust and the terms under which the trust is created. The settlor may have given instructions that trustees carry out various functions, and trust law may impose further obligations.

For taxation purposes you are responsible for

- notifying the Inland Revenue that tax is due, within six months of the end of the tax year for which it is due, where you have not received a tax return for the year
- keeping records of the income and capital gains of the trust
- completing and sending back any tax return issued to you
- paying any tax due on the income or capital gains of the trust
- supplying certificates or vouchers to the beneficiaries to show how much income they have received from the trust in the tax year and how much tax the trustees have deducted. (Inland Revenue Trusts can supply forms for you to use.)

Depending on the terms of the trust deed, you can appoint a professional adviser, such as a solicitor or accountant, to carry out some or all of these tasks. However, if you do, you are still responsible for

ensuring that all tax obligations are carried out satisfactorily.

What do I have to do when a trust ceases to exist?

As trustee, if a trust is wound up you should notify your Inland Revenue Trusts office and complete a tax return for the period up to the date the trust is wound up.

Remember, you will need to

- make provision for any tax that may be due
- consider whether the ending of the trust gives rise to a capital gains tax liability.

If the property of the trust is distributed before any outstanding tax is paid then you might have to pay that tax out of your own pocket.

The different sorts of trusts

There are a number of different sorts of trusts, but usually they fall into one of the following categories

- bare trusts
- interest in possession trusts
- discretionary trusts
- accumulation and maintenance trusts
- mixed trusts.

What is a 'bare trust'?

A bare trust, also known as a 'simple trust', is one in which each beneficiary has an immediate and absolute right to both capital and income. The beneficiaries of a bare trust have the right to take actual possession of trust property.

The property is held in the name of a trustee, but that trustee has no discretion over what income to pay the beneficiary. In effect, the trustee is a nominee in whose name the property is held and has no active duties to perform.

Example

Gary leaves his sister Juliet some money in his will. The money is to be held in trust, with Juliet entitled to the money and any income, such as interest, it earns. She also

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has a right to take possession of any of the money at any time.

This is a bare trust because Juliet is absolutely entitled to both the capital (the original money settled in the trust) and the income (any interest earned).

What is an 'interest in possession trust'?

This type of trust exists when a beneficiary, known in this case as an 'income beneficiary', has a current legal right to the income from the trust as it arises. The trustees must pass all of the income received, less any trustees' expenses and tax, to the beneficiary.

A beneficiary who is entitled to the income of the trust for life is known as a 'life tenant' (a 'liferenter' in Scotland) or as having a 'life interest' (a 'liferent interest' in Scotland).

The income beneficiary need not, and often does not, have any rights over the capital of such a trust. Normally, the capital will pass to a different beneficiary, or beneficiaries, at a specific time in the future or after a specific future event. Depending on the terms of the trust, the trustees might have the power to pay capital to a beneficiary even though that beneficiary only has a right to receive income.

A beneficiary who is entitled to the trust capital is known as the 'remainderman' ('fiar' in Scotland) or the 'capital beneficiary'.

Example

Stanley is married to Kathleen. On his death Stanley's will creates a trust and all the shares he owned are to be held in that trust. The dividends earned on the shares are to go to Kathleen for the rest of her life, and when she dies the shares pass to the children or grandchildren.

Kathleen has an 'interest in possession' in the trust as she is entitled to the income (the dividends) arising on it for the rest of her life. Unlike Juliet in the bare trust

example, Kathleen has no right to the capital, so when she dies the trust ceases and all the capital (the shares) passes to her children or grandchildren (the remaindermen or fiars).

What is a 'discretionary trust'?

Trustees of a discretionary trust generally have 'discretion' about how to use the income of the trust. They may be required to use any income for the benefit of particular beneficiaries, but the trustees can decide

- how much is paid
- to which beneficiary or class of beneficiaries payments are made
- how often the payments are made
- what, if any, conditions to impose on the recipients.

The trustees may, or may not, be allowed to 'accumulate' income within the trust for as long as the law allows rather than pass it to the beneficiaries. Income that has been accumulated becomes part of the capital of the trust.

Example

Mary puts money into trust, to be held for 20 years, for the benefit of her two grandchildren, Anne and James.

The trustees can decide how to invest or use the money and any interest it earns to benefit the grandchildren. So, when the children are young, the trustees might decide to pay for piano lessons for them. As they get older, the trustees might pay towards a wedding. After 20 years, the trustees wind up the trust and distribute all of the money to Anne and James.

What is an 'accumulation and maintenance trust'?

An accumulation and maintenance trust is one in which the beneficiaries will become entitled to the property or at least the income when they reach a certain age (no more than 25). The trustees can use the income for the maintenance of the beneficiary before the date on which that beneficiary becomes entitled to the

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property or to an interest in possession in that property.

Trustees of an accumulation and maintenance trust are given power to 'accumulate' the income of the trust until a certain date, at which time the beneficiary, or beneficiaries, are entitled to the property of the trust or to the income arising from that property.

In England and Wales, the beneficiary (unless the terms of the trust say otherwise) becomes entitled to the income from the property held in the trust when he or she reaches age 18 and an interest in possession trust is created at that point.

The position in Scotland is different, as there is no equivalent entitlement to the income of the trust at age 18. However, Scots law limits accumulation periods so accumulation and maintenance trusts will often end when the beneficiaries reach the age of majority.

Example

Bill puts money into an accumulation and maintenance trust for the benefit of his grandson Andrew.

The trustees can make payments to Andrew from the trust for his maintenance and will accumulate any remaining income. The terms of the trust give Andrew the capital and any accumulated income at the age of 25. So on his 25th birthday Andrew is entitled to all the money at that date.

What is a 'mixed trust'?

A mixed trust is a mixture of more than one type of trust, for example

- an interest in possession trust and a discretionary trust, or
- an interest in possession trust and an accumulation and maintenance trust.

Example

Two children benefit from an English accumulation and maintenance trust. Zoe reaches 18 while Sarah is still 14.

The part of the trust benefiting Zoe becomes an interest in possession trust

while the part that benefits Sarah remains an accumulation and maintenance trust until she reaches 18. So, when Zoe reaches 18 the trust becomes a mixed trust.

What is a 'settlor-interested trust'?

There are special tax rules for trusts in which the settlor 'retains an interest' in the trust, for example where the settlor receives income from the trust, but these are too specialised to be included in this. Your Acton Financial Management adviser should be able to provide you with more information about them.

What about 'non-resident trusts' and 'special trusts'?

The rules for these trusts are too specialised to be included in this, again your professional adviser should be able to provide you with more information about them. Examples include

- trusts where some or all of the trustees are not UK residents
- trusts that are not created or not administered under UK law
- various special types of UK trust such as charities, pension funds, unit trusts and trusts for employee share schemes.

The Centre for Non-Residents can provide information about the tax treatment of non-UK resident trusts and foreign law trusts.

How are trusts taxed?

This section explains briefly how different types of trusts are charged to income tax and capital gains tax. Inheritance tax is covered in the IHT series of booklets.

Different tax rules apply to settlor interested trusts, non-resident trusts and special trusts, and are not covered in this guide.

Depending on the type of trust, when income and capital gains arise in a trust tax might be charged on

- the trustees
- the beneficiaries

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- the settlor

How is a bare trust taxed?

Bare trusts are treated for tax purposes as if the beneficiary holds the trust property in his or her own name. Income tax and capital gains tax are charged on the beneficiary, as if the trust did not exist.

The beneficiary must declare any income and capital gains on his or her personal tax return. Although trustees can pay income tax on behalf of a beneficiary, it is the beneficiary who is chargeable to tax.

How is an interest in possession trust charged to income tax?

The trustees are normally chargeable to income tax on income received, so

- rent and trading income are chargeable at the basic rate (currently 22%)
- UK dividend income is chargeable at the starting rate for dividends (currently 10%) and the tax credit attached to the net dividend meets the trustees' liability
- savings income, such as bank interest, is chargeable on the trustees at the lower rate (currently 20%) Such income usually has tax deducted at source by the bank or building society, and this is taken into account in taxing the trustees.

The beneficiaries are entitled to the income from the trust after tax and expenses, and are taxed on this in the normal way. They are entitled to credit for tax paid by the trustees or deducted at source.

If beneficiaries are starting rate taxpayers or non-taxpayers they will be able to reclaim some or all of the tax paid, though tax credits on dividends cannot be paid. If they are liable at higher rates, further tax will be due.

How is a discretionary trust charged to income tax?

The trustees are liable to tax on income received at the rate applicable to trusts (currently 40%), but dividends and other

similar income are chargeable at the trust rate that applies to dividends (currently 32.5%).

All income paid to the beneficiaries carries a credit at the rate applicable to trusts. So, the payment is treated as if it had been made after the deduction of tax at that rate. If beneficiaries are basic or starting rate taxpayers, or non-taxpayers, they will be able to reclaim some or all of the tax paid. If they are liable at higher rates, further tax will be due.

If the trustees also have power to accumulate income, they can choose to do so and that income becomes additional capital of the trust. If, in later years, the trustees distribute some of the accumulated income to the beneficiaries the payment is a capital distribution, and not an income distribution. Beneficiaries are not taxable on capital distributions.

What is a 'tax pool'?

When trustees of a discretionary or accumulation and maintenance trust pay income to beneficiaries they have to ensure that they have paid enough tax to cover the tax credit at the rate applicable to trusts. Trustees, therefore, need to keep a record of tax payments, known as the 'tax pool'.

The tax pool consists of tax paid by the trustees on income they have received, and tax deducted at source, for example by banks or building societies on interest. It does not include non-payable tax credits, such as the tax credit on dividends. When the trustees pay income to beneficiaries the tax pool is reduced by the tax credit on that income.

If the tax in the tax pool is not enough to cover the tax credit needed for the payment to beneficiaries the trustees must pay the difference in their Self Assessment tax return for the year.

Example

(Using a rate applicable to trusts of 40%.) Trustees of a discretionary trust pay £60 income to the beneficiary Vicky. There is a

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tax credit of £40. Vicky is treated as receiving £100 income, from which £40 in tax (40%) has been deducted. Vicky enters this receipt and the tax credit on her personal tax return.

The opening balance in the tax pool is nil so the trustees must pay tax of £40 to cover this credit.

If there were a balance brought forward but that balance was less than £40, the trustees would have to pay enough tax in the year to make up the shortfall.

Example

(Using a rate applicable to trusts of 40% and a trust rate for dividends of 32.5%.)
Mike, a trustee, receives a net dividend of £90 (tax credit £10). He is chargeable at 32.5%, which is partly covered by the 10% non-payable tax credit.

Dividend received	£90		£90
Plus non-payable tax credit	<u>£10</u>		
Income	£100		
Tax at 32.5%	£32.50	£32.50	
Less non-payable tax credit		<u>£10</u>	
Tax payable by trustee	_____	£22.50	<u>£22.50</u>
Net income after tax	£67.50		£67.50

Mike now has net income of £67.50 (net dividend of £90 less tax paid of £22.50). Only £22.50 goes into the tax pool because the £10 dividend tax credit is not payable.

If Mike pays the net income of £67.50 to the beneficiary, the tax credit of 40% on that net payment is £45 (gross amount of £112.50 at 40%).

But if the tax pool has nothing brought forward from the previous year and there is no other income on which tax has been paid, the tax pool of £22.50 will not cover the tax credit of £45 on the payment made.

Mike will have to calculate the maximum amount he can pay in these circumstances.

Net income after tax	£67.50		
Add tax in tax pool	<u>£22.50</u>		
Total amount to cover payment to beneficiary and tax credit at 40%	£90		
Tax Credit at 40%	£36	£36	
Less tax paid in tax pool		<u>£22.50</u>	
Additional tax to pay by trustee	_____	£13.50	
Net payment to beneficiary	£54		

The beneficiary is paid net income of £54 with a tax credit of £36, which is equivalent to gross income of £90 with tax credit at 40%. Mike pays a total of £36 tax to the Inland Revenue, £22.50 tax on the dividend received and the additional £13.50. So if the trustee is relying on the dividend income to fund both the payment to the beneficiary and the additional tax he has sufficient funds to release only 60% of the actual dividend, that is $£90 \times 60\% = £54$.

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How is an accumulation and maintenance trust taxed?

In the period during which the trustees can accumulate income, the trustees and beneficiaries are taxed in the same way as in a discretionary trust, as described above.

When the accumulation period ends, the tax treatment depends on what happens to the trust property. For example, if

- an interest in possession trust is formed, then the tax treatment for trustees and beneficiaries of interest in possession trusts will apply
- it becomes a discretionary trust, then the tax treatment for trustees and beneficiaries of discretionary trusts will apply
- the trust comes to an end, and the trustees pass the trust property to the beneficiaries, the trustees may have to pay capital gains tax on any gain arising at that point, but will not have any liability on future income or gains.

How is a mixed trust charged to income tax?

For both trustees and beneficiaries, in a mixed trust the income for each part of the trust will be taxed under the rules for that type of trust. For example, the part of the trust in which there is an interest in possession will be taxed as such, while the discretionary part will be taxed as a discretionary trust.

Trusts and capital gains

Trustees are liable to tax, at the rate applicable to trusts, on any capital gains above an annual exempt amount arising for

- interest in possession trusts
- discretionary trusts
- accumulation and maintenance trusts, and
- mixed trusts.

The beneficiaries are not taxed on any trust gains and do not get credit for tax paid by the trustees.

The annual exempt amount is normally equal to half the annual exempt amount for an individual. Trustees of trusts for the benefit of people who are mentally handicapped or in receipt of certain specified allowances may be entitled to the whole annual exempt amount for an individual.

Where there is more than one trust made by the same settlor, the annual exempt amount is reduced proportionally on the basis of the number of settlements made since 6 June 1978 and still in existence.

Self Assessment

Self Assessment is the method for calculating and paying tax. If you are a trustee (except a trustee of a bare trust) you are responsible for completing and sending back a tax return for trust income and gains and paying the tax on time. Failure to do so may result in automatic interest, surcharges and penalties.

I am a trustee. When will I receive a Self Assessment tax return?

Self Assessment tax returns are generally issued each year in April, and ask for details of income and capital gains for the tax year ended on 5 April. You must complete and send us the Trust and Estate tax return

- by 30 September, if you want us to calculate the tax due, or
- by 31 January in the following year if you intend calculating your own liability.

If we get your tax return after 30 September, we cannot guarantee to let you know how much you owe in time for you to pay by 31 January. This means that you have to estimate how much to pay. If you pay too little, you will have to pay interest and possibly a surcharge.

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When do I have to pay any tax due?

As trustee, you may need to pay the tax due for any one year in three installments

- a payment on account on 31 January in the tax year
- another payment on account on 31 July after the end of the tax year, and

- a final payment on the following 31 January, if there is any more due.

The first and second payments on account are usually equal to half of the total liability for the previous year (excluding capital gains tax), while the final payment is a balancing payment.

Example

If, as trustee, your total income tax liability for 2003-04 is £5,000, and the total liability for 2004-05 is £6,000, the payments due and timetable for the tax return for 2004-05 are

31 January 2005	£2,500 due (half of £5,000)
April 2005	tax return for 2004/05 issued
31 July 2005	£2,500 due (half of £5,000)
30 September 2005	Tax return due if we are to calculate the tax
31 January 2006	£1,000 due (£6,000 due for 2004/05 less the £5,000 paid). Tax return due if trustees calculate the tax due.

There is also a payment due on 31 January 2006 of £3,000. This represents the first payment on account for 2005-06, which is half of the total liability for 2004-05.

Payments on account are not due when the income tax liability for the previous year is below £500 or if 80% or more of the tax liability is collected by deduction of tax at source.

held liable for penalties or surcharges incurred during the period he or she was a trustee.

I am not the only trustee. Are we all liable to pay tax due?

All trustees of an individual trust are jointly liable for any tax due, not just a share of it. However, where there is more than one trustee acting you normally arrange for one person, known as the 'principal acting trustee', to deal with the Inland Revenue on your behalf.

The actions of the principal acting trustee are treated as actions of all of the trustees, so

- if he or she deals with everything properly, all of you will be treated as fulfilling your tax obligations
- if he or she fails to fulfill the tax obligations, then you are all treated as failing to meet those obligations.

We can recover any tax or interest on tax from any trustee if the principal acting trustee does not pay. Any trustee can be