

Introduction

Income tax, capital gains tax (CGT) and inheritance tax (IHT) all have special rules for taxing trustees, settlors and beneficiaries. Some of the provisions vary according to the type of trust.

The residence of the trust – UK or overseas – is also relevant to some of the tax rules.

In this Essential Guide, the term ‘discretionary trust’ is used to mean a discretionary trust that is not an accumulation and maintenance trust.

Bare trusts are not taxed as trusts. Tax liabilities are the same as on an outright gift to the beneficiary.

Inheritance tax

Inheritance tax may affect the settlor, trustees and beneficiaries. The rules for interest in possession and accumulation and maintenance trusts changed significantly with effect from Budget Day in 2006 (22 March). The rules for discretionary trusts remained the same.

Trusts created after 21 March 2006

The settlor

The creation of a trust is a ‘transfer of value’ under the inheritance tax rules. The settlor is liable to inheritance tax on the loss in value to his or her estate under the normal inheritance tax rules (see the Essential Guide on ‘Inheritance tax – the key features’).

With one exception, tax is payable at 20% if, after any available exemptions, the transfer fell outside the settlor’s nil-rate band. A transfer is wholly within the nil-rate band if it, plus any other transfers of value by the settlor within the previous seven years, does not exceed the nil-rate band (£325,000 for 2009/10).

- Thus a transfer of £340,000 into a trust in 2009/10 where no exemptions were available would generate an immediate tax charge of £3,000 (i.e. 20% of £15,000) if paid by the trustees.
- If the tax is paid by the settlor the gift is grossed up and the tax becomes £3,750 (20% of £15,000/0.8).
- There might be further tax if the settlor dies within the next five years.

If the chargeable lifetime transfer involves cash, quoted shares or securities, then unless the donor’s total chargeable transfers in the past seven years (including the current transfer) exceeds the nil-rate band, the transfer does not have to be reported to HM

Revenue and Customs (HMRC). For other assets, a transfer does not have to be reported if:

- The total chargeable lifetime transfers in the past seven years does not exceed 80% of the nil-rate band; and
- The value transferred by the current gift (ignoring reliefs and exemptions) does not exceed the nil-rate band available to the transferor at the time of the gift.

A different treatment applies to gifts into a disabled trust:

- Such a gift is treated as a potentially exempt transfer (PET) at the time it is made. This means it is exempt at the time it is made and becomes liable to inheritance tax only if the settlor dies within seven years of the gift.
- A disabled trust has to satisfy specific conditions.

After property has been transferred to a trust, it is outside the settlor’s estate, and therefore escapes inheritance tax on the settlor’s death, unless the settlor has retained an interest in the trust. However, if the settlor dies within five years of making a chargeable lifetime transfer there could be IHT at the death rate less the life rate already paid.

The trustees

The trustees of most trusts are potentially liable to an inheritance tax charge every ten years on the whole of the property in the trust at the time.

The amount of tax payable depends broadly on the value of the settlor’s transfers immediately before the date of creation of the trust and the value of the trust property.

The maximum rate is 6%, but it is almost always much lower than this. Where the value of the trust property is not more than the inheritance tax nil-rate band, the ten-year charge may be nil.

A discretionary trust may also be liable to an inheritance tax exit charge whenever trust property (not income) is transferred to a beneficiary.

The calculation is complex and depends on similar factors to those that determine the ten-year charge.

The only new trusts that fully avoid these charges are:

- Trusts for ‘bereaved minors’ created on death by a parent or established under the Criminal Injuries Compensation Scheme for a minor child who will be fully entitled at age 18; or
- ‘Immediate Post Death Interest’ interest in possession trusts created on death by will or intestacy; or

- Trusts created either in the settlor's lifetime or on death for a disabled person.

The beneficiaries

The beneficiaries are not liable to inheritance tax while the property remains in the trust.

Interest in possession and accumulation and maintenance trusts created before 22 March 2006

The settlor

Before 22 March 2006 the creation, or transfer, of property to an interest in possession trust or to an accumulation and maintenance trust was a PET.

The trustees

Before 22 March 2006 the trustees of an interest in possession trust or an accumulation and maintenance trust were not subject to inheritance tax on the trust property while it was in the trust or when it was distributed.

The beneficiaries

A beneficiary with an interest in possession was treated as owning the whole of the trust property for inheritance tax purposes.

When the beneficiary dies, the value of the trust property is within the beneficiary's estate and liable to inheritance tax if their estate exceeds the nil-rate band.

Accumulation and maintenance trusts

Accumulation and maintenance trusts that existed before 22 March 2006, and where the trust provides that the trust assets will go to a beneficiary absolutely at age 18, will not be liable to periodic or exit charges.

Where the trust passes the trust assets outright to a beneficiary between age 18 and 25, an exit charge will apply for the period beyond the beneficiary's 18th birthday, i.e. the maximum theoretical charge at age 25 is $6\% \times 7/10 = 4.2\%$.

Other accumulation and maintenance trusts are subject to the discretionary trust regime from 6 April 2008. Ten-yearly anniversaries will depend on the original date of the trust, but for the first periodic charge after 5 April 2008 the charge will reflect the fact that it has not been subject to the new regime for the full ten years.

Interest in possession trusts

The previous rules for interest in possession trusts created before 22 March 2006 continue unless the interest current on that date is changed after 5 October 2008.

- If someone then takes absolute ownership, this is a transfer by the previous beneficiary as before.
- If when that interest comes to an end the trust continues, this is treated as a chargeable lifetime transfer by the outgoing beneficiary (if alive) or part of their estate (if on death). Thereafter the trust will be subject to the new regime with the exit and periodic charges.
- The previous rules continue where a new interest in possession arises in a pre-22 March trust on the death of a spouse or civil partner, regardless of when this occurs.

Life policies

Special rules apply to life policies placed in interest in possession trusts before 22 March 2006. In effect, these policy trusts are generally regarded as remaining subject to the previous tax regime where new interests come into being as a result of the death of the previous holder of the interest after 5 October 2008. Premiums will generally continue to be treated as PETs.

Overseas aspects

The country in which the trust is created has no effect on the inheritance tax liability of the settlor, trustees or beneficiary.

- Property situated outside the UK and held in a trust escapes inheritance tax if the settlor did not have a UK domicile at the time the property was transferred to the trust.
- In all other circumstances, any property placed into a trust by a UK-domiciled settlor is liable to inheritance tax, wherever the property is located.

What is meant by 'domicile' is explained in the Essential Guide on 'Residence, domicile and the taxation of overseas income'.

Income tax

In straightforward cases, the trustees are liable to income tax on trust income and beneficiaries are taxable when income is distributed to them.

However, settlors may also be taxable under anti-avoidance rules that prevent taxpayers avoiding income tax by placing assets in trusts or settling income on others under arrangements that are not a trust in the full sense.

Certain trusts for vulnerable beneficiaries may be taxed using the individual beneficiary's personal allowances, tax rates and rate bands rather than at the trust rate. This tax treatment, introduced in 2005 but

backdated to 6 April 2004, is not available automatically – it must be claimed.

Vulnerable beneficiaries include orphaned minor children and people with disabilities.

The new rules also apply to capital gains tax.

Trustees

Trustees are normally liable to income tax on trust income if at least one trustee is resident in the UK.

There is an exception to this rule where there is at least one non-UK resident trustee and the settlor was not resident, not ordinarily resident and not domiciled in the UK at the time property was placed in the trust. In such cases the trustees are not liable to income tax.

See the Essential Guide on 'Residence, domicile and the taxation of overseas income' for the meaning of the terms 'resident' and 'ordinarily resident'.

- Trustees of an interest in possession trust are liable to tax at the basic (20%) or dividend (10%) rate on all trust income whether it is paid out to beneficiaries or not.
 - Where income arises in the UK, tax deducted at source from savings income and tax credits on dividend income cover the trustees' liability in full. Other income, for example rents from letting property, is taxed at 20%.
 - Trustees are not entitled to personal allowances or any relief for the expenses of managing the trust.
- For 2009/10, trustees of a discretionary or accumulation and maintenance trust have a basic rate band which is equal to £1,000 divided by the number of trusts created by the settlor and in existence at any time during the tax year.
 - This is subject to a minimum of £200 where there are five or more trusts.
 - Income in the basic rate band is taxed at 10% (dividends) or 20% (other income).
 - Above the basic rate band, trustees are liable to tax at 32.5% on dividend income and 40% on savings and other income.
 - Any tax deducted at source and dividend tax credits are set against these liabilities.
 - Trustees' reasonable expenses are deducted in calculating the higher tax charge but not in calculating the income chargeable at the basic rate. Where there are different types of income the calculation may be complex.
 - There is no personal allowance.

- There is a complication where trusts distribute dividend income to beneficiaries. The income that the beneficiaries receive is not differentiated by source. In order to preserve the rule that the 10% tax credit attached to dividends cannot be repaid, trusts that distribute dividend income sometimes have to pay additional tax to ensure that they have paid enough tax to cover the 40% tax credit attached to the beneficiaries' income (see below). Because of this, the distribution of dividend income to beneficiaries may result in the beneficiaries receiving a smaller amount after tax than if they owned the shares personally.
- The lower tax rates on the basic rate band element may also result in the trustees not paying enough tax to cover the 40% tax credit. If this happens the trustees must make up the difference. This is only likely to occur where the trustees distribute a large proportion of the trust income.

Beneficiaries

Beneficiaries of any type of trust receive the trust income as net income with a credit for the trustees' tax.

- For income from an interest in possession trust, the tax credit is 10% or 20%, depending on whether the income is dividends or other income respectively.
- For income from a discretionary or accumulation and maintenance trust, the tax credit is always 40%.
- There is no tax credit with income from a non-resident trust that does not pay UK tax.

The grossed up income is part of the beneficiary's taxable income and the tax credit goes towards the beneficiary's personal tax liability.

- A beneficiary can set personal allowances against income from a trust.
- The tax credit can be wholly or partly repaid where it exceeds the beneficiary's tax liability.
- Basic rate taxpayers will have no further tax to pay on trust income and will be entitled to a repayment if the income carries a 40% tax credit.
- Higher rate taxpayers will receive the income with the correct tax deducted.

Settlors

There are two cases where tax law treats trust income as the settlor's. In these instances, the settlor is taxed on the income even if he or she has not received it. The rules apply to all types of trust.

- The first is where either the settlor or the settlor's spouse or civil partner has retained any interest in the trust. This prevents a taxpayer avoiding income tax by putting assets into a trust while still enjoying a benefit.
- The second is where the trust is for the benefit of an unmarried child of the settlor under 18 years old. The rule extends to any income received by a child that is derived from a gift from a parent.
 - Income of £100 or less is ignored.
 - There is an exception for certain bare trusts for children created before 9 March 1999. If they meet a number of conditions, the income is taxed as the child's.

Where a settlor is taxable on trust income, the beneficiary is not also liable to tax on that income.

A settlor who receives a capital sum from a trust is chargeable to income tax up to the amount of any undistributed trust income.

If the capital sum is more than the undistributed trust income at the time, the excess is carried forward to match against any future undistributed income for up to the next 11 years. A capital sum would include loans and loan repayments.

Capital gains tax

Capital gains tax may be payable when assets enter or leave a trust, when trustees dispose of trust assets and sometimes when beneficiaries dispose of their interests in a trust. In addition beneficiaries may be taxable on trust gains under anti-avoidance rules.

Trustees

Trustees treated as UK resident (under the same rules as for income tax) are liable to tax on chargeable gains arising from disposals of trust property under broadly the same capital gains tax rules that apply to individuals.

With two exceptions, trustees are entitled to an annual exemption equal to half the individual annual exemption, so for 2009/10 it is £5,050.

- Certain settlements for the disabled and trusts for vulnerable beneficiaries are entitled to the full individual annual exemption of £10,100.
- Where a settlor has created more than one trust since 6 June 1978, the normal trust exemption is divided equally between them, with a minimum exemption per trust of £960.

For this purpose, life assurance policy trusts are included, but registered pension scheme trusts (including those for former retirement annuity policies) are excluded. The creation of several discretionary trusts on the successive days can have inheritance tax benefits.

Trustees are taxable at 18% on all gains arising from 6 April 2008, regardless of the type of trust. For gains before 6 April 2008 the tax rate was 40%.

Trustees can benefit from the private residence exemption on property that a beneficiary occupies as an only or main residence under the terms of the trust.

Property leaving a trust

When a beneficiary becomes absolutely entitled to trust assets, those assets are deemed to have been sold by the trustees at their market value, and immediately reacquired by them as a nominee or bare trustee for the beneficiary.

- The trustees are taxable on any chargeable gain that results from this deemed disposal.
- There is no capital gains tax on a distribution in cash.
- In some circumstances, the trustees and beneficiary can elect for the gain to be held over. This means the trustees have no tax to pay.

Instead, the gain held over is deducted from the market value of the asset in determining the beneficiary's 'cost' of the asset. When the beneficiary disposes of the asset, it is this reduced cost that is used in calculating the beneficiary's chargeable gain.

- Holdover relief is available on transfers out of any trust where the assets are business assets, for example shares in an unlisted trading company.
- Holdover relief is also available on any transfers out of a trust where an exit IHT charge can arise. This includes all discretionary trusts and virtually all trusts created since 22 March 2006.
- There is no capital gains tax when a beneficiary becomes absolutely entitled to settled property because of the death of a beneficiary entitled to an interest in possession for a pre-22 March 2006 trust.
- There is no capital gains tax where a beneficiary's interest ends but the property does not leave the trust.

Property entering a trust

A settlor who transfers property into a trust is liable to capital gains tax as if the property had been sold at its market value. It makes no difference whether or not the settlor is also a beneficiary of the trust.

Provided the settlor does not have an interest in the trust, holdover relief is available where either the assets are business assets or the transfer is a chargeable lifetime transfer (which covers almost all transfers into trusts). The settlor can claim this relief unilaterally.

- A settlor has an interest for this purpose if the settlor or the settlor's spouse or civil partner can benefit from the trust property or there is an arrangement whereby the settlor can benefit in future. There are some limited exceptions.
- Holdover relief that has been given can be clawed back in certain circumstances where the settlor later acquires an interest in the trust.
- Holdover relief is not restricted on transfers to certain trusts for beneficiaries with disabilities.

Disposals of beneficiaries' interests

In general, there is no capital gains tax where a beneficiary disposes of an interest in a trust, unless the beneficiary acquired that interest for money or other valuable consideration.

Settlors' liability on trust gains

Since 6 April 2008, a UK resident settlor of a UK trust is not liable to tax on chargeable gains of the trust where the settlor has an interest in the trust.

However, a settlor is liable to capital gains tax on gains of a non-resident trust if he or she is resident or ordinarily resident in the UK in the year in which the gains arise.

For this purpose the settlor has an interest in the trust if any of the following can benefit in any way:

- The settlor.
- The settlor's spouse or civil partner.
- Any child or stepchild of the settlor or spouse or civil partner, and the spouse or civil partner of any such child.
- Any company controlled by any such persons and any company associated with any such company.

For trusts created after 16 March 1998, or to which property has been added since that date, the settlor has an interest if a grandchild of the settlor or spouse, or the spouse of any such grandchild, can benefit.

The definition of settlor's spouse does not extend to the widow or widower.

Settlors who are non-UK domiciled are eligible to be taxed under this rule on the remittance basis. They may have to make a claim. (See the Essential Guide on 'How residence affects your tax'.)

Non-UK domiciled settlors were not liable to UK tax on trust gains up to 5 April 2008. Trustees can elect to exclude unrealised trust gains that accrued up to 5 April 2008 from being taxed.

Beneficiaries' liability on trust gains

Beneficiaries of non-resident trusts are liable to capital gains tax on trust gains if they are either resident or ordinarily resident in the UK.

- Their liability is limited to the amount of any capital payment they receive from the trust. The detailed calculation is complex.
- Notional interest at 10% a year (subject to a maximum of 60%) is added to the tax where there is a delay between the gain arising in the trust and a capital payment being made to the beneficiary.
- A beneficiary who is non-resident for a period of less than five complete tax years may be liable to tax on trust gains when he or she returns to the UK.

Summary

The main income tax, capital gains tax and inheritance tax liabilities are summarised for each type of trust in the following table.

Type of trust	Income tax*	Capital gains tax	Inheritance tax (IHT)
Bare	Beneficiary taxable at own tax rates.	Gift in is disposal – holdover relief only on business assets. Beneficiary taxable at own rates on disposals by trust.	Gift into trust is PET (potentially exempt transfer). Assets are treated as if in beneficiary’s estate.
Interest in possession	Trustees taxable at 10/20%. Beneficiary may reclaim/pay extra at own rates.	<i>Pre 22.3.06 trusts</i> Gift in was disposal – holdover relief only on business assets.** Trustees taxable on trust disposals at 18% with trust exemption. Transitional reliefs generally mean deemed disposal on death of life tenant (tax-free uplift) or a beneficiary becoming absolutely entitled to assets – business holdover relief only. <i>Post 21.3.06 trusts</i> As discretionary trust.	<i>Pre 22.3.06 trusts</i> Gift into trust was a PET. Transitional reliefs mean assets are generally treated as if in beneficiary’s estate. <i>Post 21.3.06 trusts</i> As discretionary trust.
Accumulation and maintenance	Trustees taxable at 40/32.5%; income in basic rate band of between £200 and £1,000 taxed at 10/20%. Beneficiary may reclaim/pay extra at own rates.	<i>Pre 22.3.06 trusts</i> Gift in is disposal – holdover relief only on business assets.** Trustees taxable on trust disposals at 18% with trust exemption. Holdover relief on assets leaving trust in some circumstances. <i>Post 21.3.06</i> Accumulation and maintenance trusts can no longer be created.	<i>Pre 22.3.06</i> Gift into trust is PET. No IHT within trust and assets not treated as if in beneficiary’s estate. No IHT on property leaving trust. Transitional rules applied until 5 April 2008. <i>Post 21.3.06</i> Accumulation and maintenance trusts can no longer be created.
Discretionary	Trustees taxable at 40/32.5%; income in basic rate band of between £200 and £1,000 taxed at 10/20%. Beneficiary may reclaim/pay extra at own rates.	Gift in is disposal – holdover relief on any assets.** Trustees taxable on trust disposals at 18% with trust exemption. Holdover relief on any assets leaving trust.	Gift into trust is a chargeable lifetime transfer. Periodic charge every 10 years, maximum rate 6%. Exit charge where property leaves trust.

* Assuming income is not paid to a beneficiary who is a settlor’s unmarried child aged under 18.

** Provided the settlor cannot benefit from the trust.

Other taxes

Trustees may occasionally become liable to other taxes. For example, they may be liable to stamp duty land tax when they purchase land. Trustees who trade may have to register for value added tax.

There are generally no special rules for trusts, and liability is calculated in the same way as for individuals.

Trusts in tax planning

Trusts have many uses in tax planning. Some uses exploit specific tax reliefs, while in other cases overseas trusts may be used in arrangements that rely more on the secrecy that surrounds them than on their legal efficacy.

Any arrangements that rely on HMRC not finding out are probably illegal (i.e. tax evasion) and carry a risk of penalties if they are discovered. Some contrived arrangements fail in the courts, while others succeed and are then stopped by new legislation, which might be retrospective.

These schemes often focus around either sidestepping the rules that make gifts ineffective for inheritance tax where the settlor retains a benefit or avoiding inheritance tax and capital gains at the same time.

There is a cycle consisting of a tax-saving scheme being marketed, HMRC challenging it, often in the courts, new legislation being passed where HMRC loses or is not confident of winning its challenge, and eventually new schemes emerging because anti-avoidance legislation rarely plugs every single loophole or itself creates new loopholes.

To enable HMRC to identify and stop unacceptable tax avoidance schemes more quickly, promoters of income tax, capital gains tax, corporation tax and stamp duty land tax avoidance schemes now have to disclose the arrangements to HMRC, which registers them and issues a reference number. At present disclosure is not required for inheritance tax schemes.

Taxpayers who use a registered scheme must show its reference number in their tax return. The fact that a scheme is registered does not mean that it is in any way approved or that it achieves the intended effect.

Entering into complex tax avoidance schemes is a high risk activity and usually involves high costs. Nevertheless, there are uses of trusts that will not be challenged, subject of course to taxpayers declaring all

the tax liabilities that do arise and providing complete and accurate information to HMRC. Only a few possibilities are mentioned here.

Inheritance tax planning

Trusts give individuals the opportunity to reduce inheritance tax on their estate by passing assets on during their lifetime without making absolute gifts and by using the nil-rate band on death.

Any trusts created during lifetime are only fully effective in reducing tax on an estate if the settlor survives at least seven years.

Discretionary trust of the nil-rate band

A simple tax planning device is to create a discretionary trust with a gift that falls within the donor's inheritance tax nil-rate band.

No inheritance tax is payable and the donor can elect to hold over any capital gain. Inheritance tax ten-year and exit charges are likely to be small or nil.

Discretionary trusts in wills

A discretionary trust of the nil-rate band may also be set up in the will of the first to die of a married couple.

Until 8 October 2007 this was commonly done where the testator wanted to leave all the rest of the assets to the surviving spouse but not waste the nil-rate band.

Since 9 October 2007 this has become less important because a spouse's nil-rate band is generally not wasted if all assets are left to a surviving spouse.

- When a person has died, any unused nil-rate band can now be transferred to the estate of a surviving spouse or civil partner who dies after 8 October 2007. It does not matter when the first death occurred.
- On the second death, the nil-rate band in force at that time is increased by an amount calculated by the proportion of the nil-rate band that was left unused when the first partner died. The effect is to uplift the first partner's unused nil-rate band to its value at the second partner's death.

However, there can still be a tax advantage in using the nil-rate band on the first death, if it is likely that assets passed down will appreciate in value at a greater rate than the nil-rate band will be uplifted.

Another reason to use the nil-rate band on first death is that in some circumstances not all the unused nil-rate band can be passed on. This is because the amount of additional nil-rate band that any one surviving spouse or civil partner can accumulate is limited to the value of the nil-rate band in force at the

time of their death. This restriction may be relevant where a spouse or partner has had more than one marriage or civil partnership.

Non-tax considerations are important. For example, a person may want to ensure that their children inherit their assets. Passing all assets to a spouse or partner on the first death may not waste a nil-rate band, but if the survivor remarries, the family's wealth may never reach the intended beneficiaries.

Using a discretionary trust preserves flexibility over how the assets will eventually be distributed.

Another use of discretionary trusts in wills is where the testator wants to leave open the precise distribution of assets among beneficiaries. Although wills can be varied, this requires the consent of all beneficiaries affected and is not possible where any of them are minors.

Again, a discretionary trust is more reliable. If the trust lasts for no more than two years, inheritance tax is the same as if the deceased had made the eventual distribution to the beneficiaries.

Non-domiciled settlors

Under inheritance tax rules, individuals who are not domiciled in the UK lose that status once they have been resident in the UK for 17 out of the previous 20 tax years. An individual who is about to become UK domiciled can prevent overseas assets from becoming liable to inheritance tax by placing them in a trust.

Passing on the family home

Creating a trust to pass on the family home is normally ineffective for inheritance tax because if the settlor continues to live in the home rent-free, he or she has retained a benefit. Schemes involving trusts were devised to try to get around this problem.

The introduction of stamp duty land tax on 1 December 2003 made it impossible to avoid stamp duty land tax on the sale of the property to the trust. Before then it was possible to avoid stamp duty by not completing the sale.

From 6 April 2005, income tax ('pre-owned assets' tax) is charged on the benefit people get by having free or low-cost enjoyment or use of certain assets they formerly owned, or provided the funds to purchase. The charge is designed to penalise those inheritance tax saving schemes that bypass the gifts with reservation rules. It applies to all arrangements set up from 18 March 1986 onwards if the former owner of an asset still enjoys a benefit, with some limited exceptions.

To avoid income tax, taxpayers may be able to undo the arrangement. If this is not possible, they can avoid income tax by electing for the asset to be subject to inheritance tax on death.

- In principle, the election must be made by 31 January following the end of the first tax year in which income tax arises. For 2005/06, the election therefore should have been made by 31 January 2007. However, HMRC has the discretion to accept late elections without restriction.
- If an election is made, the property in question is treated as part of the former owner's taxable estate for IHT purposes, while they continue to enjoy it, in essentially the same way as under the 'gift with reservation' rules.

The income tax charge on 'pre-owned assets' is not limited to arrangements involving property or even arrangements involving trusts, but also extends to chattels (tangible movable assets, such as works of art) and financial products.

Insurance and pensions

It is possible to enter into an insurance policy that will pay out a lump sum on death that can be used to pay inheritance tax. Such policies should be written in trust so that the payout falls out of the estate.

Premiums paid would normally be covered by the IHT annual and normal expenditure from income exemptions.

The same is true for death benefits under pension schemes, which are exempt from the changes in the Finance Act 2006.

Capital gains tax planning

Extensive anti-avoidance legislation has made trusts not a very effective vehicle for reducing tax on chargeable gains.

Crystallising a gain

Occasionally it is beneficial for an individual to crystallise a gain for tax purposes. A disposal into a trust in which the settlor is also a beneficiary can achieve this without loss of ownership of the asset.

Income tax

It is possible for individuals to avoid tax on overseas income through using an overseas trust as the trustees are not taxable in the UK. However, the settlor must not be in a position to benefit from the trust. There is also legislation that taxes income from assets that have been transferred abroad in some circumstances.

Conclusion

Trusts have many legitimate uses and should be considered in any estate planning exercise.

However, there are many circumstances in which tax can arise in connection with trusts.

Care must be taken that the settlor is not merely exchanging one tax liability for another.

Anyone who enters into any arrangements involving trusts should make sure they understand in advance all the risks involved and what fees will be charged, especially for overseas trusts which are often costly to administer.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at May 2009, which are subject to change.