

GUIDE TO TRUSTS

This guide explains how common types of trusts interact with Capital Gains Tax (CGT), Inheritance Tax (IHT) and Income Tax, helping you understand not just the rules but how they apply in practice.

1. DISCRETIONARY TRUSTS

Discretionary trusts are often the starting point where flexibility is required. They allow trustees to adapt to changing circumstances, making them particularly valuable in long-term estate planning.

That flexibility, however, comes with a more complex and often heavier tax position.

Income Tax

Since April 2025, smaller discretionary trusts have benefited from a simplified approach:

- Income of £500 or less is treated as nil for Income Tax purposes
- Once income exceeds this level, all income becomes taxable

Above this threshold:

- Income is taxed at 45% for most income
- Dividend income is taxed at 39.35%
- No personal allowances are available

When income is distributed to beneficiaries:

- It is paid with a 45% tax credit
- Beneficiaries may reclaim tax depending on their individual tax position

Capital Gains Tax

Discretionary trusts operate within a compressed Capital Gains Tax framework:

- Annual exemption is £1,500

- This may be reduced if multiple trusts exist
- Gains are taxed at 24% (or 34.075% for carried interest)

Key planning considerations include:

- Losses must first offset gains in the same year
- Unused losses can be carried forward
- There is no Capital Gains Tax uplift on death
- Holdover relief may be available to defer gains
- Main residence relief may apply in certain circumstances

Inheritance Tax

From an Inheritance Tax perspective, discretionary trusts fall within the relevant property regime:

- A 20% entry charge applies where transfers exceed the nil rate band (£325,000)
- Additional charges include:
 - 10-year periodic charges up to 6%
 - Exit charges when capital leaves the trust

A key advantage is that:

- Trust assets are not included in the beneficiary's estate

Other points to watch

- Settlor-interested rules may result in the settlor being taxed on trust income
- Pension death benefits paid after age 75 are subject to a 45% charge before reaching the trust
- Only certain trustee expenses are deductible

In practice, discretionary trusts are most effective where control and flexibility are the primary objectives.



2. BARE TRUSTS

Bare trusts sit at the opposite end of the spectrum. They are simple and transparent, with the beneficiary treated as the outright owner of the assets.

Income Tax

- All income is taxed as the beneficiary's income
- The beneficiary uses their own allowances

For minors:

- Where a parent provides the funds, income over £100 is taxed on the parent
- Where funded by grandparents or others, income is taxed on the child

Capital Gains Tax

- Gains are treated as those of the beneficiary
- The beneficiary's full Capital Gains Tax exemption applies
- Holdover relief is not available

Inheritance Tax

- Transfers into a bare trust are Potentially Exempt Transfers (PETs)
- The assets form part of the beneficiary's estate

Other points to watch

- Commonly used for minors, including for pension death benefits
- The beneficiary gains full control at age 18
- Trustees must act only for the beneficiary's benefit

Bare trusts are best suited where outright ownership is intended.

3. TRUSTS FOR VULNERABLE BENEFICIARIES

Where protection is the primary objective, particularly for disabled individuals or vulnerable minors, these trusts provide a structured solution with favourable tax treatment, provided strict conditions are met.

Income Tax

- Trustees are responsible for Income Tax but may claim relief where income is used for the vulnerable beneficiary

In practice:

- Income can effectively be aligned with the beneficiary's tax position
- Where the beneficiary is a non-taxpayer, tax (up to 45%) may be reclaimed

This creates valuable planning opportunities, particularly in long-term care scenarios.

Capital Gains Tax

- Trustees can reduce their Capital Gains Tax liability by comparing:
 - The tax payable by the trustees
 - The tax that would have been payable by the beneficiary

Additionally:

- Disabled beneficiaries (or a child whose parent has died) are entitled to the full Capital Gains Tax exemption rather than the reduced trust exemption

Inheritance Tax

- Typically treated as a Potentially Exempt Transfer when created
- Not subject to 10-year periodic charges or exit charges

Instead, Inheritance Tax arises at key points:

- On the death of the beneficiary
- Or when the trust ends

Other points to watch

- The trust must operate solely for the vulnerable beneficiary
- Failure to meet these conditions may result in treatment as a discretionary trust

These trusts offer a balance between protection and tax efficiency but require careful administration.

4. INTEREST IN POSSESSION TRUSTS

Interest in possession trusts separate income and capital rights. One beneficiary (the life tenant) has a right to income, while capital is preserved for others.

Income Tax

- Trustees pay:
 - 20% on savings income
 - 10.75% on dividend income
- No personal allowances apply to trustees

Beneficiaries:

- Are treated as receiving the income
- May reclaim tax depending on their allowances

Capital Gains Tax

Treatment depends on when the trust was created:

Pre-22 March 2006:

- Capital Gains Tax uplift on death of the life tenant

Post-22 March 2006:

- No uplift
- Gains taxed under standard trust rules

Inheritance Tax

Pre-22 March 2006:

- Creation treated as a Potentially Exempt Transfer
- Assets generally included in the beneficiary's estate

Post-22 March 2006:

- Treated as Chargeable Lifetime Transfers
- 10-year and exit charges apply

Other points to watch

- Expenses reduce income paid to beneficiaries but not the trustee's tax liability
- Immediate post-death interest trusts arise on death and provide immediate income rights

These trusts are particularly relevant in estate planning where income and capital need to be separated.

5. LIFE ASSURANCE POLICIES IN TRUST

Life assurance policies are commonly written in trust to enable efficient payment of proceeds outside the estate.

Income Tax

- Withdrawals may trigger a chargeable event
- Tax liability depends on whether the settlor is alive and UK resident

Capital Gains Tax

- Generally not applicable

Inheritance Tax

- Typically held outside the settlor's estate

Other points to watch

- Tax may fall on the settlor, trustees, or beneficiaries depending on circumstances

These structures are primarily used for administrative efficiency and estate planning.



6. EXCLUDED PROPERTY TRUSTS

Excluded Property Trusts are commonly used in international planning, although recent changes mean they require closer review.

Income Tax

- Depends on the residence status of the parties involved

Capital Gains Tax

- Linked to the residence of the trustees

Inheritance Tax

- Remains outside Inheritance Tax if established and funded before 30 October 2024
- Later additions may bring assets into scope

Other points to watch

- Changes from April 2025 affect long-term planning
- Residency status must be monitored closely

7. OFFSHORE TRUSTS AND TRUST RESIDENCE

Offshore trusts introduce additional complexity, particularly where UK residents are involved.

Income Tax

- UK residents may still be taxed on trust income if they benefit

Capital Gains Tax

- UK residents may be taxed on gains of offshore trusts
- Creating a trust is treated as a disposal at market value

Inheritance Tax

- Depends on domicile and trust structure

Other points to watch

- A UK-resident trustee may bring the trust within the Capital Gains Tax regime
- The settlor may have a personal Capital Gains Tax liability when establishing the trust
- Holdover relief may be available in certain cases



8. ACCUMULATION AND MAINTENANCE TRUSTS

These trusts are designed to provide for children, typically up to age 25, allowing income to be accumulated or distributed as needed.

Income Tax

- Income can be accumulated or distributed at the trustees' discretion

Capital Gains Tax

- Standard trust rules apply

Inheritance Tax

- Pre-22 March 2006 versions could benefit from favourable treatment if conditions were met

Other points to watch

- Modern versions are generally aligned with discretionary trust rules

9. FINAL POINT: PENSIONS AND INHERITANCE TAX

Pensions are becoming increasingly relevant in trust planning.

Income Tax

- Pension death benefits may be subject to Income Tax depending on the age of the member at death

Capital Gains Tax

- Not typically applicable

Inheritance Tax

- From April 2027, Self-Invested Personal Pensions (SIPPs) and Small Self-Administered Schemes (SSASs) will fall within Inheritance Tax

Other points to watch

- Trusts are likely to play a greater role in pension planning
- While pensions cannot be written into trust directly, trusts can receive death benefits or hold distributed funds