There's a catch

As HMRC reviews the treatment of trusts, Gordon Watt suggests removing a tax trap that lurks for trusts for disabled beneficiaries.

Evolving international standards of transparency are driving changes to domestic law. Whatever Brexit turns out to mean, it is a good bet the Fifth Anti-Money Laundering Directive will be implemented by January 2020. This is likely to allow persons with a legitimate interest – including journalists and non-governmental organisations working on anti-money laundering or countering terrorist financing – to access information about the ultimate beneficial owners of trusts. Who knows what future reforms may bring or what legitimate interest may come to encompass?

Trusts and legitimate aims

Traditionally, in some quarters, trusts have been viewed predominantly as a vehicle for tax avoidance so perhaps an overhaul to increase transparency is due and this is one of the factors under consideration in HMRC's consultation – *The Taxation of Trusts: A Review* (tinyurl.com/HMRC-08895). But now that's underway, it is important also to reflect on whether enough is done to support trusts that are a suitable mechanism to achieve a legitimate aim.

One such example is when trustees are needed to discharge responsibilities that would be beyond a beneficiary because of their disability. For instance, a child whose condition is such that, even as an adult, they would be unable to administer assets if they were transferred to them directly. Assume also that the child's parent does not wish to simply give assets to a relative or friend on the basis of an informal understanding that they will be used to benefit the child. Even if the bond of trust is strong, and any tax disadvantages are overlooked, who knows what may befall the good Samaritan – divorce, bankruptcy, ill health, lottery win or emigration.

Does someone wishing to make enduring provision for a disabled person have an alternative to establishing a trust – in other words, a legally recognised entity putting ownership and administration of assets in the hands of persons capable of discharging associated responsibilities while securing the beneficiary's long-term interests? For non-high net worth individuals at least, the answer in many cases is likely to be no and in such circumstances a trust performs a socially beneficial function. Does the tax system do enough to support such settlements?

Providing for a person with a material disability often involves a lifetime settlement. Contrast this with the settlor or testator planning the tax-efficient devolution of their estate on death. But since 2006 discretionary trusts and lifetime created interests in possession are subject to a tough fiscal environment. Settlement triggers a chargeable transfer and, usually, a disposal for capital gains tax albeit this is often relievable. There is a principal charge to inheritance tax and exit charges. Indeed, arguably, the whole point of the relevant property regime is to discourage the making of such settlements.

Trusts for disabled persons already enjoy a number of advantages, but there is a clear omission. More on that later, but first a reminder of the framework – the rules have evolved over time and the picture is now somewhat complex. Which regime applies depends on when the trust was established.

Until 2013, disabled meant:

- suffering from a mental disorder making the beneficiary incapable of administering property or managing their affairs;

Key points

- Trusts have a legitimate purpose to protect vulnerable beneficiaries.
- Does the tax system do enough to support these arrangements?
- Qualifying trusts for disabled beneficiaries receive favourable inheritance tax treatment.
- Neutral treatment for trust income and gains can be claimed.
- Hold-over relief on the establishment of a trust is arguably deficient.
- Should relief under TCGA 1992, s 260 be extended?

- receiving a disability living allowance at the highest or middle rate; or
- receiving an attendance allowance, which in essence amounted to needing frequent attention in connection with basic needs or continual supervision.

Settlements before March 1981

Before March 1981, under IHTA 1984, s 74, there could be no interest in possession during the life of the disabled person. The terms of the trust have to secure that, while the disabled beneficiary survives, any settled property applied is applied 'only or mainly' for their benefit.

If the settlor was the disabled person, the settlement did not result in a chargeable transfer. The settled property is not subject to the relevant property regime and there is no deemed interest in possession. Instead, a charge to inheritance tax arises when settled property ceases to be held in the trust except on a distribution to the disabled beneficiary. Among other things, that charge arises when the beneficiary dies. There is no capital gains tax free uplift on death, but hold-over relief may be available because of the charge to inheritance tax.

From 1981 to 2013

Trust terms must secure that 'not less than half' of trust property applied during the life of the disabled person must be applied for their benefit (IHTA 1984, s 89). As before, the trust must be discretionary.

Inheritance tax is levied in a new way. Although there can be no actual interest in possession, the disabled person is deemed to be beneficially entitled to one. The result is: no chargeable lifetime transfer on settlement; no ten-yearly charge to inheritance tax; and no exit charge. Instead, the settlement is a potentially exempt transfer (PET) or, if made by the disabled person, there is no transfer of value. These are therefore vanishingly rare examples of post-2006 lifetime settlements that are not subject to the relevant property regime.

Other forms of trust also qualify for special inheritance tax treatment:

- The settlor who reasonably expects to become disabled and places his assets in a discretionary trust from which he may benefit on terms securing that any trust property is applied for his benefit (IHTA 1984, s 89A).
- An actual interest in possession trust for the benefit of a disabled person, on terms securing that any property applied during their lifetime is applied for their benefit (IHTA 1984, s 89B).
- A self-settlement by a settlor reasonably expecting to become disabled on terms under which the settlor acquires an actual interest in possession, with the same conditions regarding application of trust property.

In each case, the settlement is a PET or, if made by the disabled person, there is no charge to inheritance tax because it's a non-event.

Since December 2013, a capital gains tax-free uplift applies on the death of the disabled person in each case.

Trusts since 2013

The now current definition of a disabled person was expanded from July 2013 to include individuals receiving a personal independence payment, an increased disablement pension, constant attendance allowance, or an armed forces independence payment (FA 2005, Sch 1A para 1).

The terms of the trust must now secure that *any* settled property or income arising from it and applied during the life of the disabled person is applied for their benefit. Advances of less than £3,000 a year are excepted (IHTA 1984, s 89(3)).

Trustees' tax

Special treatment of income and gains accruing to trustees of trusts for vulnerable beneficiaries is also available if claimed (FA 2005, s 23 to s 45). The trust must restrict application of income and capital as above. A vulnerable person includes a disabled person within the meaning of FA 2005; in other words, as for inheritance tax purposes under IHTA 1984, s 89.

Tax on income or gains arising is no more than it would have been if received directly by the disabled beneficiary. So, using income tax as the example, the trustees' liability is calculated as if there was no special treatment and the vulnerable beneficiary's notional liability is also calculated on the assumption that trust income has been received directly. The trustees may claim the difference as a deduction from their tax liability.

"Tax on income or gains arising is no more than it would have been if received directly by the disabled beneficiary."

Neutrality

The special treatment of income and gains is neutral in tax terms. This is in the sense that the trust is looked through in calculating liability to tax. The logic here is that a trust is necessary because of the beneficiary's circumstances. So the normal rules taxing trust income and gains can reasonably be disapplied – a coherent result. This produces the same outcome that would have been obtained if trust assets could have been given free and clear to the beneficiary.

The inheritance tax rules have a materially different effect, although the same rationale justifies special treatment. The consequence of s 89 and associated provisions is that the relevant property regime does not apply to whichever type of qualifying lifetime settlement is made. But the trust is not taken out of inheritance tax – it is subject to a less onerous regime. Settling property into trust is a PET. So, depending

Chargeable Transfer 1

A settlor transfers shares worth £300,000 into a discretionary trust meeting the conditions in IHTA 1984, s 89. The transfer is a potentially exempt transfer.

There is no available annual exempt amount. Assume tax is due on gains above the basic rate limit.

	£
Deemed market value	300,000
Less:	
Base cost	50,000
Chargeable gain	250,000
Tax at 20%	50,000

The settlor pays the tax, but dies two years later so the PET becomes chargeable. There is no available nil rate band. Inheritance tax at 40% is applied to the value of the original transfer disregarding the capital gains tax paid. Inheritance tax of £120,000 is payable (40% of £300,000). The total tax associated with transferring the assets is £170,000.

Chargeable Transfer 2

As in ***Chargeable Transfer 1***, a settlor transfers shares worth £300,000 into a discretionary trust meeting the conditions in IHTA 1984, s 89.

The transfer is a potentially exempt transfer, but hold-over relief (under an amended version of TCGA 1992, s 260) defers liability to capital gains tax. When the settlor dies within two years inheritance tax of £120,000 is due. The trustees sell the shares some time later for £300,000. Again, assume there is no available annual exempt amount and that tax on gains is due at 20%.

		£
Sale proceeds		300,000
Less:		
Base cost	50,000	
Inheritance tax paid	120,000	
		170,000
Chargeable gain		130,000
Tax at 20%		26,000

The total tax due is £146,000, but inheritance tax paid may be relieved against capital gains tax due so there is no double charge to tax.

on the available nil rate band, the amount settled, and how long the settlor survives, there is the potential that no tax will be due but there is no guarantee, and there's tapering in the rate over time.

However, that is not neutrality in the sense above. The establishment of a trust is not looked through; rather the settlor is put into the same position that would have applied to a person settling a lifetime interest in possession before 2006. The main benefit is for a settlor with an insufficient available nil rate band who avoids inheritance tax liability at the point of settlement.

“Settlors contemplating transferring non-business property to a s 89 trust are less fortunate.”

Impact of capital gains tax

Inheritance tax is really only half the picture though. Because a gift to a settlement is a disposal to a connected person deemed to be at market value, the availability of relief from capital gains tax can be decisive for a potential settlor.

Unfortunately, as things stand, there is no targeted relief from capital gains tax for those settling assets to benefit disabled beneficiaries.

Hold-over relief is usually disallowed when a trust is settlor interested. But this does not apply if a settlor, spouse or dependant child has an interest and the trust secures that any property applied during the life of a disabled beneficiary is applied for their benefit and the usual restrictions on the application of income and capital apply. So hold-over relief may sometimes be available when, for example, a settlor establishes a trust to benefit a disabled child. But this is in limited circumstances only.

Although hold-over relief may be claimed under TCGA 1992, s 260 on a transfer to a relevant property trust it is not available on a transfer to a trust qualifying under s 89 because there is a PET or a non-event for inheritance tax purposes.

Alternatively, a transfer to any trust (whether relevant property or not) of the right kind of asset (business) allows for hold-over relief under TCGA 1992, s 165. But, in essence, it is a coincidence that relief is available in this situation. Settlements of business property are relieved on separate grounds, to shelter family businesses from tax until a sale generates the funds to pay the liability.

Settlors contemplating transferring non-business property to a s 89 trust are less fortunate. They face an immediate tax liability on gains above the annually exempt amount, with the possibility of an inheritance tax bill to follow if they do not survive for seven years. On the gift to trust, there will be no sale proceeds from which to pay any tax due at settlement. And, worse, if the PET fails – so inheritance tax becomes due later – no account is taken of any capital gains tax borne by the transferor in calculating the value of the transfer for inheritance tax purposes. This is illustrated by ***Chargeable Transfer 1***.

Does the outcome of ***Chargeable Transfer 1*** seem reasonable? Let's remember that the reason for removing these trusts from the relevant property regime is to avoid a liability at the time of settlement, recognising that it is the beneficiary's circumstances that drive settlement. Surely there needs to be a corresponding relaxation of capital gains tax as well at the point of settlement.

Solution

It is widely acknowledged that the tax regime applying to trusts for disabled persons is overly complicated. But, as well as tackling complexity, something should be done about the capital gains tax problem described.

It is clear that an immediate capital gains tax liability can present difficulties for a settlor in the absence of sale proceeds from which to pay the tax. This is recognised in the legislation by, for example, TCGA 1992, s 165. Should those transferring non-business assets to a trust for a disabled person be in a worse position? If not, what should be done?

The suggestion is this. We are used to thinking of TCGA 1992, s 260 as designed primarily to avoid an immediate double charge to inheritance tax and capital gains tax on the creation of a relevant property trust. But it goes further. In some cases, hold-over relief can be claimed under it even if no inheritance tax is due because there is an exempt transfer. Examples here are a transfer to a political party, maintenance fund for historic building, or the transfer of property of outstanding scenic, historic or scientific interest. In these cases, hold-over relief is available to encourage transfers to deserving recipients.

It would be relatively straightforward to extend the scope of s 260 to transfers to trusts qualifying under s 89 and associated provisions. Inheritance tax would be due on the death of the settlor within seven years assuming there was insufficient available nil rate band. In the meantime, hold-over relief would be available to defer liability to capital gains tax until a disposal generates funds to meet it.

In terms of the interaction between the taxes, any inheritance tax eventually paid could be relieved against the capital gains tax liability on disposal as already provided for by s 260. Bear in mind that hold-over relief does not extinguish liability but defers it. The definition of disabled person and conditions on the use of trust capital and income should prevent abuse. This is illustrated by ***Chargeable Transfer 2***.

Conclusion

HMRC's consultation on the taxation of trusts notes the valuable role these arrangements play for those unable to manage their own affairs. The government has committed to enabling the straightforward use of trusts if they are an appropriate mechanism to achieve a legitimate goal. And it wishes to promote the use of existing reliefs in relation to trusts for vulnerable beneficiaries.

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Extending relief under s 260 in the way suggested would be an appropriate and important step in that direction. It would promote the effectiveness of under-utilised existing reliefs in s 89 and related sections and it would reasonably facilitate the creation of settlements for the benefit of those who need and deserve them.

HMRC has recently extended the deadline for responses to its consultation document to 28 February 2019. *Taxation* readers with an interest in this subject, but who have been constrained by the demands of the 31 January self-assessment tax return deadline, have another few weeks to provide their opinions on trusts for vulnerable beneficiaries in particular and trusts more generally. ●

Planning point

Capital gains tax hold-over relief may not be available on a transfer to a trust for a disabled person. Further, the settlor's death within seven years can give rise to an inheritance tax liability as well.

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FIND OUT MORE

- HMRC consultation document *The Taxation of Trusts: A Review*: tinyurl.com/HMRC-08895
- Implications of the trusts consultation document: tinyurl.com/yaburwtm
- Changes to the inheritance tax regime for trusts introduced by Finance Bill 2015-16: tinyurl.com/ydeb4hdp