Trusts and Capital Gains Tax

Contacts

Please phone:
- the number printed on page TR 1 of your tax return
- the SA Helpline on **0845 9000 444**
- the SA Orderline on **0845 9000 404** for helpsheets

or go to **www.hmrc.gov.uk**

This helpsheet explains how UK resident trusts are treated for Capital Gains Tax. It also deals with situations where a person disposes of an interest in a settlement. But it is only an introduction. If you are in any doubt about your circumstances, you should ask your tax adviser. We will also be pleased to help. You can also consult our *Capital Gains Manual*, which explains the rules in more detail, at **www.hmrc.gov.uk**

This helpsheet will help you fill in the *Capital gains summary* pages of your tax return.

If you need information concerning liability to Inheritance Tax for a trust please phone the Probate and Inheritance Tax Helpline on **0845 3020 900**. This helpline is open from 9am to 5pm Monday to Friday (except Bank Holidays). You can find useful information, including a basic guide and the *Inheritance Tax Manual*, at **www.hmrc.gov.uk**

The overriding principle is that the trustees are taxable on the basis that the 'settlement' is an entity separate from the trustees, the settlor and the beneficiaries.

The principles of Scottish trust law are in significant respects different from those of the rest of the UK. Trustees of Scottish trusts should note that the English expression 'life tenant' used in this helpsheet includes a 'liferenter', and that in Scotland the 'settlor' is more often referred to as the 'truster'.

The Income Tax and Capital Gains Tax liabilities of trusts are handled by specialist offices. For this reason, as far as possible, any queries concerning your liabilities or responsibilities as a trustee should be directed to one of these offices. You can find out how to contact a Trust Office, and other useful basic information, at **www.hmrc.gov.uk**

Liability to Capital Gains Tax may depend upon the application of trust law to particular facts. Although the *Capital Gains Manual* provides some information on trust law, in such circumstances you may need to take professional advice or consult specialist textbooks. This helpsheet assumes that you are familiar with the basic terms and principles of trust law.

As a general rule we do not ask to see the deeds but we may do so if the liability to Income Tax or Capital Gains Tax depends upon the construction of the deed.

This helpsheet does not deal with special trusts such as employee trusts or charitable trusts.

For more information about the liability of settlors and beneficiaries of non-resident trusts go to **www.hmrc.gov.uk** Limited information is contained in Helpsheet 301 *Beneficiaries receiving capital payments from non-resident trusts: calculation of the increase in tax charge* and Helpsheet 299 *Non-resident trusts and Capital Gains Tax*. Or you can contact:

HMRC Trusts & Estates
Non-Resident Trusts
Ferrers House
Castle Meadow Road
NOTTINGHAM NG2 1BB

Phone: **0845 604 6455**
If calling from abroad: **+44 1872 245 359**

Who is liable to Capital Gains Tax on the gains of trustees?

As a general rule, the liability to tax on the gains accruing to the trust falls on the trustees. However, there are certain exceptions:

- if the trust is a bare trust, see page 3, the trustees are ignored for Capital Gains Tax purposes, and the relevant beneficiaries are treated as if they had carried out the particular transactions themselves
- in certain cases where assets are transferred to beneficiaries, the gain on that disposal can be the subject of a hold-over claim, see Helpsheet 295 *Relief for gifts and similar transactions*. The chargeable gain of the trustees is reduced and the cost of the asset to the beneficiary, when they dispose of the asset, is similarly reduced
- in the case of non-resident trusts, liability to Capital Gains Tax may fall on the beneficiaries or the settlor. This helpsheet does not deal with non-resident trusts in detail; more information is in Helpsheet 299 and Helpsheet 301 or go to **www.hmrc.gov.uk**
- we regard the trustee who has completed the tax return as primarily responsible for paying the tax. But if that trustee fails to do so, we can demand payment from any person who was a trustee in the year in which the gain arose, or any subsequent year
- in certain circumstances where a beneficiary has received trust property, and the trustees have not paid Capital Gains Tax, we can recover the tax from the beneficiary.

What is a 'settlement'?

Liability to Capital Gains Tax falls on 'the trustees of a settlement'. For Capital Gains Tax, the word 'settlement' refers to the situation where property is held in trust, except where it is a bare trust. It covers all cases involving settled property. From the year ended 5 April 2007 the same definitions are used for the general purposes of taxing trustees to Income Tax, although the word settlement has a different meaning in the situation where individuals are taxed on the income of others.

The question often arises as to whether a particular situation means that there is one settlement or several. This is important because liability is calculated on the basis that each settlement is a separate taxable entity. So for example:

- each settlement has its own annual exempt amount
- appropriations of assets within a settlement have no effect for Capital Gains Tax
- losses belong to the settlement
- the rules for identification of shares apply by reference to the settlement.

The question as to whether there is one settlement or several, is considered in detail in the *Capital Gains Manual*. If there are several settlements ultimately derived from one deed or will, this can only be so if either:

- the will (or exceptionally, deed) created several settlements from the outset, or
- an event has occurred by which a new settlement came into existence and the trustees of the new settlement became 'absolutely entitled' as against the trustees of the original settlement. This is a deemed disposal for Capital Gains Tax.

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We accept that it is possible for a will to create several settlements if the property in each is entirely separate from the property in the other(s) and the trusts declared in the will are entirely separate or will merge only in totally unexpected circumstances.

Example 1

John Brown dies leaving his property to trustees to hold for his widow Anne for life. After her death they are to hold half for his son George for life and half for his daughter Mary for life, with the property going absolutely to their respective children alive at John Brown's death.

After Anne Brown's death the trustees divide the property into two separate funds. This is one single settlement. At the beginning neither the property nor the trusts are separate. The appropriation into two funds does not change this.

Since 6 April 2006, it has been possible, if certain conditions are met, to elect irrevocably, for both Income Tax and Capital Gains Tax purposes (but not only one of these taxes), that a separate fund within the settlement be regarded as a 'sub-fund settlement' separate from the 'principal settlement'. This means that for all purposes except for the computation of the annual exemption (see page 4), this is regarded as a separate settlement.

You can find more information in the *Capital Gains Manual* and the *Trusts, Settlements and Estates Manual* at **www.hmrc.gov.uk** You will also find a form SFE1 *Sub-fund election,* for making the election, there.

What is a 'bare' trust?

For Capital Gains Tax purposes a bare trust is one where the beneficiaries are 'absolutely entitled as against the trustee'. This generally is true where either:

- the trustee has no right to deal with the property except with the consent of the beneficiaries, or
- the beneficiaries, all of which have similar interests, can take control of the property on giving due notice to the trustee.

Also, it is a bare trust where the beneficiaries could take control but for being infants or under some other legal disability. There are certain cases, particularly in the case of trusts of land, where the beneficiaries all have similar interests but have agreed contractually that the trustees should deal with the assets in a particular way. These are bare trusts.

The right of the trustees to retain the property until tax, costs or other outgoings have been met is disregarded for these purposes.

It is possible for a situation to arise in which a beneficiary is absolutely entitled to part of the property. In this case the trust is partially a bare trust.

Where there is a bare trust, anything done by the trustee is regarded as done by the beneficiary. A transfer from the trustee to the beneficiary is disregarded.

Example 2

Henry Green sets up a trust under which his grandchildren Trevor and Charlotte are entitled to the property if they reach the age of 25. The assets are quoted shares. On 1 May 2011 Trevor reaches 25. He is entitled to half the property, so the trustees are treated as having made a disposal of half the property for Capital Gains Tax purposes.

They retain the shares and then sell a block on 1 May 2012. Half of these shares are regarded as sold by them and the gain calculated by reference to the original cost. The other half are treated as sold by Trevor who has a gain based on the value at 1 May 2011.

On 1 October 2012 the trustees hand over to Trevor half of the remaining shares. That is ignored. If Trevor then sells some of the shares, his cost is the value on 1 May 2011.

What are the rates of tax?

Trustees' gains are taxed at 28%. If a vulnerable beneficiary claim is made, the trustees are taxed on the amount that would be paid if the gains were taxed on the vulnerable beneficiary directly. The beneficiary may pay a lower rate of Capital Gains Tax. See the *Capital gains summary notes* for a description of the Capital Gains Tax rates that apply to individuals. A claim to use the special treatment for vulnerable beneficiaries for a tax year requires an irrevocable election to be made for this treatment.

What is the annual exemption?

In the normal case, the trustees are entitled to an annual exempt amount of half that allowed to individuals, namely £5,300 for 2011–12. The trustees may allocate their annual exempt amount in the most beneficial way.

If, however, the settlement was made after 6 June 1978 and the settlor (or one of them) made other settlements after that date, the annual exempt amount for each is reduced. The settlement and the other settlements made by the settlor form a group. The annual exempt amount for each settlement is £5,300 divided by the number in the group (up to five). If the settlement has two or more settlors, you take the largest group. The unused annual exemption of one settlement cannot be transferred to another.

Where a sub-fund election has been made you calculate what would have been the annual exempt amount for the settlement but for the election. If there are two or more settlements in the class consisting of the principal settlement and the sub-fund settlements, apart from ones which are not taken into account for the reasons given in the next paragraph, then this figure is divided by the number in the class.

Certain types of settlement are not taken into account in the group. These include:

- charitable trusts
- non-resident settlements
- certain types of pension fund
- settlements for a disabled person, as defined.

Settlements with no income or chargeable gains are taken into account in the group. For settlements where the only asset is a life policy see page 9 of this helpsheet.

Where the main beneficiary is a mentally disabled person or a person in receipt of Attendance Allowance or a Disability Living Allowance by virtue of entitlement to the care component at the highest or middle rate, the annual exemption is £10,600. Any other settlements for a disabled person with the same settlor are grouped separately for the purpose of the post – 6 June 1978 reduction.

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A settlement qualifies for this larger annual exemption if the terms of the settlement are such that during the disabled person's lifetime:

- not less than half the property which is applied will be applied for their benefit, and
- they are entitled to not less than half the income, or none of the income may be applied for the benefit of anyone else.

The test applies for each year separately. So if, for example, the life tenant no longer qualifies for Attendance Allowance, the settlement's status changes at the end of that year. This test is applied separately from the test to determine whether the settlement is for a vulnerable beneficiary.

The second bullet, immediately above, is significantly different from the equivalent Inheritance Tax test.

Disposal by trustees

Where trustees dispose of assets, the same principles apply in most cases as for individuals in making the computations. The principal exception applies to cases where shares are sold which derive from stock dividends.

What happens when a beneficiary disposes of an interest under a settlement?

The basic rule is that where a beneficiary disposes of an interest under a settlement, including an interest in remainder, it gives rise to neither a chargeable gain nor an allowable loss.

This does not apply where the interest was acquired by the beneficiary or a predecessor in title for a consideration in money or money's worth, except for an exchange of interests under the settlement.

Except where the disposal is as described in the next paragraph, the exemption does not apply to interests in a non-resident settlement, or where the settlement has ever been non-resident, or the property in the settlement has come from a non-resident settlement.

Where such a beneficiary becomes absolutely entitled to all or some of the property, that is a disposal or part disposal of the interest in question.

It is quite common for a life tenant to surrender their life interest, or for the life tenant to buy the interest of the remainderman or the other way round. If the result of such a transaction is that all the interests under the settlement are held by one person, then that person is absolutely entitled to the trust property, and there is a deemed disposal by the trustees. But this occasion is covered by the exemption so far as the beneficiary is concerned provided one of the interests would otherwise be exempt.

There may be a deemed disposal by the trustees of some or all of the settled property if both of the following are true:

- the settlement is one in which during a defined period either the settlor or the settlor's spouse or civil partner or minor child has an interest, or property has been transferred in, from such a settlement, and
- a person disposes of any kind of interest in the settlement for consideration.

If you think that this provision may affect your trust, please consult your tax adviser.

What happens when the life tenant dies?

For the purposes of this section, except paragraph 7, in the case of a death after 21 March 2006 the expression 'qualifying interest in possession' refers to the following:

- an interest in possession in existence on 21 March 2006
- an 'immediate post-death interest'
- a 'transitional serial interest'
- a 'disabled person's' interest in possession
- a 'bereaved minor's' interest in possession
- an interest in possession in an '18-25 trust' where the death of the person with the interest occurs before the beneficiary reaches 18.

A person has an interest in possession if they have the immediate right to receive the income from the property or to the use or enjoyment of it.

You can find more information about these types of interest in the *Capital Gains Manual* and the *Inheritance Tax Manual*. Broadly speaking, these are those cases where the person with the interest in possession who dies has continued since 22 March 2006 for Inheritance Tax purposes to be treated as owning the relevant settled property at death.

For Inheritance Tax purposes, certain interests in property which is not settled are treated as interests in possession in settled property. This treatment does not apply for Capital Gains Tax purposes. However, Scottish proper liferents and Northern Irish interests which stand limited for life have special treatment when the holder of the interest dies. There are no corresponding interests in England and Wales.

If a life tenant or other person with a qualifying interest in possession dies and the property continues to be settled property or a beneficiary becomes absolutely entitled to the property, the trustees are deemed to have disposed of it and reacquired it at market value. There is no gain or loss **unless** the trustees acquired the asset subject to a hold-over claim, see Helpsheet 295 *Relief for gifts and similar transactions*. The trustees' chargeable gain is the lower of the held-over gain and the actual chargeable gain **or** where, on the death of the life tenant, the property reverts to the settlor, the trustees are treated as disposing of the property at a consideration that gives rise to neither a gain nor a loss.

If a beneficiary becomes absolutely entitled to the assets on the death of the life tenant, they will acquire the asset at market value but it will continue to be held by the trustees as bare trustees until they transfer the legal ownership.

If the deceased had a qualifying interest in possession in part of the property, the treatment described above applies to the corresponding part of the property only.

The death of a life tenant or other person with a qualifying interest in possession may well be a chargeable transfer for Inheritance Tax purposes either because it is one of those interests bulleted in this section, or because, as a result, property leaves the settlement. To find out more call our helpline or look at the online manual.

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What other reliefs are available to trustees?

Trustees may be entitled to, or be able to claim, many of the Capital Gains Tax reliefs, although some of these reliefs are limited to individuals and, for some, the conditions of relief are different from those for individuals.

You may want to refer to the following helpsheets:

Helpsheet 275 *Entrepreneurs' Relief*

Helpsheet 283 *Private Residence Relief*

Helpsheet 295 *Relief for gifts and similar transactions*

Helpsheet 297 *Enterprise Investment Scheme and Capital Gains Tax*.

For other reliefs, you may need to consult the *Capital Gains Manual* or the relevant legislation to see whether trustees can make claims. Please note that because of changes in conditions for relief, helpsheets for the relevant tax year should be used, if possible.

What is meant by becoming absolutely entitled and what are the tax consequences?

When one or more persons become absolutely entitled to trust property as against the trustees, for Capital Gains Tax purposes there is a deemed disposal at market value by the trustees of the property in question, and they thereafter hold the property as bare trustees.

The main examples of beneficiaries becoming absolutely entitled are:
- the termination of a settlement after a term of years
- the death of a life tenant where one or more of the beneficiaries are now entitled to the income and the capital
- the exercise by the trustee of a power of advancement or appointment to release capital to a beneficiary
- the acquisition of the life interest by the remainderman or the interest in remainder by the life tenant
- the occurrence of a contingency such as a particular birthday or marriage
- an agreement by the beneficiaries to terminate the settlement.

There is also a deemed disposal when the trustees of one settlement become absolutely entitled as against the trustees of another settlement, including the occasion when a sub-fund settlement comes into existence.

There is no further disposal for Capital Gains Tax purposes when the relevant property is formally transferred to the beneficiaries or other trustees following the occasion of absolute entitlement.

Where a beneficiary becomes absolutely entitled as against the trustees of a settlement, the trustees should consider whether there is any liability to Inheritance Tax. To find out more phone our helpline or look at the online manual.

What happens when successive contingencies affect the property?

Suppose that a trust deed provides that the property is to be held for such of Tom and Sarah as reach the age of 25 and, if more than one, in equal shares. Is there a deemed disposal when Tom reaches 25, or not until Sarah reaches 25?

Tom and Sarah have interests which are 'contingent' on their reaching their 25th birthdays. A contingency is an event which may not necessarily happen.

The general rule is that when Tom reaches the age of 25 he becomes absolutely entitled to his share of the property. So the trustees then are treated as making a disposal of half the property. But there are two important exceptions:

- the first is where the trustees have an express power to appropriate the property in settlement of a particular interest and have not yet done so. In this case absolute entitlement will occur when the trustees exercise their power. If they do not do so then Tom and Sarah will become jointly absolutely entitled to the trust property on Sarah's 25th birthday. Where a settlement is governed by Scottish law, the trustees have such a power automatically unless it is specifically excluded in the deed or will. This is not the case in the rest of the UK, where it must be specifically provided
- the second is that under English law, where the asset in question is land, absolute entitlement does not occur until the final contingency happens. The same may apply in certain cases of other assets.

Separate settlements

Trustees (or other persons) may exercise powers of appointment or advancement, declaring new trusts over some of the settled property, in such a way that a new settlement is brought into existence.

If this is so, then this is a deemed disposal because the trustees of the new settlement become absolutely entitled, as against the trustees of the old one. For more information please ask your tax adviser or consult the *Capital Gains Manual*.

We particularly consider that no new settlement has been created if either:

- the trusts declared in the deed of appointment, etc. are not exhaustive, that is, they do not cover every possibility, or, in particular, can be revoked, or
- the trustees do not have the power to delegate to other trustees.

The above paragraph does not apply, however, where the transfer is to another settlement that already exists.

It is possible, with the trustees' consent, for all the beneficiaries to agree to vary the terms of the settlement. If some of the beneficiaries are minors or unborn, or where there is an alimentary liferent, an interest only possible under Scottish law, or a protective life interest, the consent of the court must be obtained. Depending on the facts, this may give rise to one or more new settlements.

Losses

The treatment of losses for trustees is the same as that for individuals:

- the allowable losses of the current year are deducted from the chargeable gains without any restriction, and any surplus losses are carried forward
- losses of previous years are deducted from gains of the current year
  - after the current year's losses have been deducted, and
  - only insofar as is needed to reduce the net gains to the annual exempt amount.

Losses may be used in the way that is most beneficial to the trustees.

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When:

- a beneficiary becomes absolutely entitled to an asset as against the trustee, and
- there is an allowable loss on the deemed disposal, and
- the loss cannot be set against the trustees' gains on that occasion or occurring earlier in the tax year

that loss passes from the trustees to the beneficiary, but the beneficiary can only set that loss against gains on a disposal of that asset, or in the case of a disposal of land an asset derived from that asset.

When all the following apply:

- when the trustees acquired the asset a claim to hold-over relief was made (see Helpsheet 295 *Relief for gifts and similar transactions*)
- the person who transferred the asset to the trustees on that occasion, or any person connected with them, has acquired or entered into arrangements to acquire an interest in the settlement, and
- in connection with the acquisition any person has received or become entitled to receive any consideration

the trustees cannot set any losses, whenever incurred, against the gain on the disposal of the asset.

Insurance policies held in trust

It is quite common for life policies to be held in trust. In such a case there is a settlement for the purposes of Capital Gains Tax and the principles described in this helpsheet apply.

A charge to Income Tax may arise when the policy comes to an end, or on certain other designated occasions, in particular where consideration is received; see Helpsheet 320 *Gains on UK life insurance policies* and Helpsheet 321 *Gains on foreign life insurance policies*.

If, as is commonly the case, the only asset of the settlement is the life policy, a liability to Capital Gains Tax may arise for the first time on the occasion when the relevant insurance company demutualises or is taken over. The insurance company will normally tell you what the tax position is. If you are liable to Income Tax and/or Capital Gains Tax, and you have not received a tax return, you must notify us of your chargeability within six months of the end of the relevant tax year.

For the purposes of the annual exempt amount (see page 4) a settlement of this kind is one of the settlements making up the group of settlements made by the settlor. The absence of income or gains in a particular year is immaterial.