

## TRUSTS AND CAPITAL GAINS TAX

**The purpose of this Help Sheet is to explain briefly the way in which UK resident trusts are dealt with for Capital Gains Tax.**

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 United Kingdom. Trustees of Scottish trusts should note that the English expression 'life tenant' used in this Help Sheet includes a 'liferenter', and that in Scotland the 'settlor' is more often referred to as the 'truster'.

**This Help Sheet is only an introduction. If you are in any doubt about your liability to Capital Gains Tax as trustee, settlor or beneficiary you should ask your tax adviser.**

Your Inland Revenue office will also be pleased to help. You can ask to see the Inland Revenue Capital Gains Manual which explains the relevant rules in detail.

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.

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

Although as a general rule the Tax Office does not ask to see the deeds, an exception may be made where the liability to Capital Gains Tax depends upon the construction of the deed.

**This Help Sheet does not deal with special trusts such as employee trusts or charitable trusts.**

Although the Help Sheet mentions non-resident trusts, it does not deal with the liability of settlors or beneficiaries of such trusts in detail; nor does the Capital Gains Tax Manual. If you need more information ask the Orderline for *Help Sheets IR301: Calculation of the increase in tax charge on capital gains from non-resident, dual resident and immigrating trusts*, and *IR299: Non-resident trusts and Capital Gains Tax*, or contact the Financial Intermediaries and Claims Office:

FICO (Non-resident Trusts)  
St. John's House  
Merton Road  
Bootle  
Merseyside  
L69 9BB  
Tel: 0151 472 6000.

(*Help Sheet IR299* deals with the liability of settlors of non-resident trusts.)

## 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 settlor or the settlor's spouse can or do benefit from the trust, the settlor is liable on the gains of the trustees
- if the trust is a bare trust, see page 2, 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 *Help Sheet IR295: Relief for gifts and similar transactions*. Effectively this means that the gain of the trustees will become taxable when the beneficiary disposes of the asset
- in the case of non-resident trusts, liability to Capital Gains Tax may fall on the beneficiaries or the settlor. This Help Sheet does not deal with non-resident trusts in detail; more information is in *Help Sheet IR299*.

In the first instance the Inland Revenue regards the trustee who has completed the Tax Return as responsible for paying the tax. But if that trustee fails to do so, payment can be demanded from any person who was a trustee in the year in which the gain arose or subsequently.

In certain circumstances where a beneficiary has received trust property, and the trustees have not paid Capital Gains Tax, the Inland Revenue 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' has its normal meaning of a situation where property is held in trust, except where it is a bare trust. 'Settlement' does not, so far as resident trusts are concerned, bear the wider meaning that it has for Income Tax purposes. It does, however, cover all cases involving settled property, even though exceptionally they may not be regarded as settlements for Income Tax purposes.

The question often arises 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 whether there is one settlement or several is considered in detail in the Capital Gains Tax 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.

The Inland Revenue accepts 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 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 Mrs John 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.

### 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 means that **either**:

- the trustee has no right to deal with the property except with the consent of the beneficiaries, **or**
- the beneficiaries 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.

The right of the trustees to retain the property until tax, an expense 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

Mr Brown 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 1.5.99 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 1.5.2000. 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 1.5.99. On 1.10.2000 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 1.5.99.

### WHAT ARE THE RATES OF TAX?

The gains of the trustees are taxed at the rate applicable to trusts of 34%.

### 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 £3,550.

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 £3,550, 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.

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.

Settlements where all the gains are taxable on the settlor are taken into account in the group. So are those with no income or chargeable gains.

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 core component at the highest or middle tax rate, the annual exemption is £7,100. Any other settlements for a disabled person with the same settlor are grouped separately for the purpose of the post 6 June 1978 reduction.

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 is applied for his or her benefit, **and**
- he or she is 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.

These provisions are significantly different from those which provide special treatment for Inheritance Tax purposes for trusts for disabled persons. See booklet IHT16, page 26, available from the Orderline.

### WHAT HAPPENS WHEN THE SETTLOR CAN OR DOES BENEFIT?

Where the settlor or the settlor's spouse has an actual or potential entitlement of any kind under the settlement or actually enjoys a benefit, such as a loan or use of property, the chargeable gains are taxable on the settlor.

The rules now correspond closely to those applying for Income Tax, except that a settlement for minor children does not come within these rules if that is the only reason for the Income Tax rules applying.

The chargeable gains and allowable losses of the trustees are calculated in the normal way, except that there is no annual exempt amount. Taper relief for the chargeable gains of the trustees, see *Help Sheet IR279: Taper relief*, is given at this stage. An amount equal to the net gains is then treated for all purposes as gains of the settlor and should be shown as attributed gains in the settlor's Tax Return.

The settlor must set against these gains, so far as not already used, his or her own annual exemption. If the trustees have more losses than gains, the surplus losses cannot be set against the gains of the settlor. The settlor can no longer set his or her losses against these gains.

Any claims or elections that are considered appropriate must be made by the trustees. In considering whether any Capital Gains Tax relief is due, the fact that the settlement falls within the rules providing for the assessment of the settlor are not taken into account. So, for example, the trustees may have made a chargeable gain and now wish to defer the gain under the conditions for investment under the Enterprise Investment Scheme, see *Help Sheet IR297: Enterprise Investment Scheme and Capital Gains Tax*. In order that the trustees can qualify for deferral relief, the qualifying investment must be made by the trustees, not the settlor.

These rules do not apply in the year of the settlor's death nor, if the settlement is within these rules solely because of the spouse's benefit, in the year of death of the spouse.

If the settlor's spouse can only benefit after the death of the settlor, this benefit is not taken into account when determining whether the settlor is liable.

### Disposals by trustees

Where trustees dispose of assets, the same principles apply in most cases as for individuals. Two types of case which cause particular difficulties are:

- enhanced stock dividends. The Income Tax and Capital Gains Tax treatment for trustees is set out in Inland Revenue Statement of Practice SP4/94, which is included in leaflet IR131 *Statements of Practice*, available from the Orderline
- exempt demergers. The treatment for trustees for Capital Gains Tax is set out in the Inland Revenue Capital Gains Tax Manual, to which you can refer.

### WHAT HAPPENS WHEN A BENEFICIARY DISPOSES OF AN INTEREST IN 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, it does not apply to interests in a non-resident settlement, or where the settlement has ever been non-resident, or the property 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 his or her life interest, or for the life tenant to buy the interest of the remainderman or vice versa. 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.

## WHAT HAPPENS WHEN THE LIFE TENANT DIES?

- 1 Subject to paragraph 6 below, this section applies where a life tenant or other person with an interest in possession dies. A person has an interest in possession if he or she has the immediate right to receive the income from the property or to the use or enjoyment of it.
- 2 If the property continues to be settled property, the trustees are deemed to have disposed of it and reacquired it at market value, but, subject to paragraph 4 below, there is no gain or loss.
- 3 If on the death of the life tenant a beneficiary becomes absolutely entitled to the property, subject to paragraph 4 below there is no gain or loss on that deemed disposal, but the beneficiary is treated as acquiring it at market value.
- 4 If the trustees acquired the asset subject to a hold-over claim, see *Help Sheet IR295: Relief for gifts and similar transactions*, their chargeable gain is the lower of the held-over gain and the actual chargeable gain.
- 5 Where the deceased had an interest in possession in part of the property, the uplift in paragraph 2 and the exemption in paragraph 3 apply to the corresponding part of the property only.
- 6 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 neither gain nor loss.
- 7 The death of a life tenant or other person with an interest in possession is likely to be a chargeable transfer for Inheritance Tax purposes. Please refer to Booklet IHT16, pages 6 to 10, available from the Orderline.

## 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 wish to refer to the following Help Sheets which can be obtained from the Orderline:

*IR283: Private residence relief*

*IR289: Retirement relief and Capital Gains Tax*

*IR295: Relief for gifts and similar transactions*

*IR297: Enterprise Investment Scheme and Capital Gains Tax.*

For other reliefs you may need to consult the Capital Gains Tax Manual or the relevant legislation to see whether trustees can make claims.

## WHAT IS MEANT BY BECOMING ABSOLUTELY ENTITLED AND WHAT ARE THE TAX CONSEQUENCES?

When one or more beneficiaries 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
- 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 no further disposal for Capital Gains Tax purposes when the relevant property is formally transferred to the beneficiaries following the occasion of absolute entitlement.

Where a beneficiary becomes absolutely entitled as against the trustee of a settlement, other than an interest in possession settlement, the trustees should consider whether there is any liability to Inheritance Tax, see Booklet IHT16, available from the Orderline.

## 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.

The question whether a new settlement has been created is dealt with in Inland Revenue Statement of Practice SP7/84, which is included in leaflet IR31 *Statements of Practice*, available from the Orderline, and in the Capital Gains Tax Manual.

The Inland Revenue in particular considers 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 life rent, 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:

- 1 The allowable losses of the current year are deducted from the chargeable gains without any restriction, and any surplus losses are carried forward.
- 2 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, before taper relief to the annual exempt amount.

In the case of a settlement under which the settlor can benefit, there is no restriction of the losses brought forward.

When a beneficiary becomes absolutely entitled before 16 June 1999 as against the trustee, allowable losses in respect of that property, or property represented by that property, which cannot be deducted from the gains arising prior to and including that occasion, are transferred to the beneficiary as if they were losses arising to him or her on that occasion.

Where the occasion of absolute entitlement is on or after 16 June 1999, the previous paragraph is only applicable in respect of an allowable loss accruing to the trustees on the actual occasion of absolute entitlement. Furthermore, the beneficiary can only set that allowable loss against a disposal or part disposal of the same asset or, in the case of a disposal of an interest in land, an asset derived from the asset to which the beneficiary became absolutely entitled.