SIFA Professional

TRUST SIFA Pro INVEST

Pru
part of M&G plc

The SIFA Professional Handbook of Trustee Investment

Eighth edition, 2021

For professional use only

The SIFA Professional Handbook of Trustee Investment

Eighth edition, 2021 by The Technical team at Prudential part of M&G plc, together with input from SIFA Professional on features relating to the 2019 SRA Code of Conduct rules.

Please note: This handbook is designed for use by financial and professional advisers and its contents are believed to be accurate as at April 2021. However, no warranty is given by the authors or the sponsors or SIFA Limited as to the accuracy of the contents and no responsibility can be accepted for any errors or omissions or for any course of action taken in reliance on the handbook.

Contents

A. Introduction 5

Introduction from SIFA Professional 5

B. Law and Regulation Relating to Trusts 8

B.1 Types of Trust 8

B.2 Trustees' Statutory Powers And Duties 16

B.3 Trustees' Common Law Responsibilities 23

B.4 Trustees' Remuneration and Expenses 31

B.5 Referrals to Financial Advisers 32

B.6 UK Law Outside of England & Wales 33

B.7 The Trust Registration Service (TRS) 34

C. The Taxation of Trusts 41

C.1 The Modernisation of Trust Taxation 41

C.2 Income Tax 44

C.3 Capital Gains Tax 52

C.4 Inheritance Tax 54

D. Investments and their Tax Treatment 66

D.1 Collective Investment Schemes 67

D.2 Onshore And Offshore Investment Bonds 69

E. Matching Investments to Trusts 75

E.1 Discretionary and Accumulation & Maintenance (A&M) Trusts 75

E.2 Interest In Possession (IIP) Trusts 83

E.3 Bare Trusts 84

E.4 Charities 85

Precedents 89

1. Trust Fact-Find for Professional Trustees 90

2. Financial Adviser’s Trust Factfind 98

3. Financial Adviser’s Report on Referred Trust 100

4. Minutes of Trustees’ Meeting 102

A. Introduction

Introduction from SIFA Professional

SIFA was originally founded in 1992 as Solicitors for Independent Financial Advice with the objective of bringing together financial advisers and solicitors and assisting them to provide a joined-up service to their mutual benefit and that of their clients.

In 2021, SIFA still offers compliance services via SIFA Support Services but since 2009, via SIFA Professional it has offered support and consultancy to quality financial advisory businesses looking to build professional compliant relationships with solicitors. Throughout that time, we are proud to have been Affiliate Partners of the Law Society of England and Wales. As a consequence of that influential partnership, the SIFA Professional Directory of Financial Advisers **sifa-directory.info** is actively promoted to the solicitor community.

Affiliate Partner
The Law Society

SIFA Professional is an Affiliate Partner of the Law Society

The Legal Services Act of 2007 and subsequent developments in the legal market have dramatically changed the landscape. Solicitors are being encouraged by their regulator to respond to increasing competition, both regulated and unregulated, by taking a more holistic view of their clients' needs and associating with other professionals whose business offerings are complementary to their own.

Financial services has been singled out both by the SRA and the Legal Ombudsman as being a potentially suitable area of diversification by solicitors. Crispin Passmore, the then Executive Director for Policy at the Solicitors Regulation Authority, speaking at a press reception to mark SIFA's 25th anniversary in February 2017, commented:

"One thing we are learning about the modern market is that people find it difficult to characterise whether their problem is legal, financial, business or whether it is even solvable. Problems do not fit into neat compartments.

Therefore, we are seeing firms taking an increasingly holistic approach to problem solving. And many firms benefit from the expertise and specialism of financial advisors, solicitors, accountants and others".

Mr. Passmore concluded by saying: "*The future of regulation will make it easier for independent financial advisors and others to work with solicitors. And it will be a two-way street*".

The changes telegraphed by Passmore, arrived in the form of the new Standards and Regulations in November 2019. The new regime simplified the regulation of solicitors, raising professionalism with more concise principle governed rules and added for the first time a 'Code of Conduct' for the firm management as well as for the individual solicitor. This should ensure a more structured approach to the provision of legal services and in turn lead to a more considered process in the selection, by solicitors, of the correct financial advisory partners.

The new firm 'Code' places the onus on the management and in particular, the Compliance Officer for Legal Practice to implement proper processes and systems for third-party referral. As with all referrals, those to financial advisers, must be demonstrably in the 'clients' best interests' so the due diligence and consideration in choosing those to collaborate with is critical. Of course, one of the most common arenas for collaboration is to ensure, in line with the Trustee Act, the assets of trusts are invested and reviewed appropriately for their objectives.

Investment thinking and the construction of portfolios also continues to move on. Gone are the days when the standard recommendation for a trust portfolio of whatever size was a portfolio of individual securities. The emphasis now is on collective investments, whether active or passive, which provide the risk-reduction benefits of multi-asset diversification combined with cost control.

Nevertheless, the principles on which the first edition of the Trustinvest guide was based in 1998 hold good, and these are now reflected in s4 of the Trustee Act 2000: namely that the suitability of trust investment relates not just to the types of investment employed and the requirement for diversification, but also the benefits of reduced administration and tax savings available through the selection of the most appropriate investment 'wrappers'.

This eighth edition of Trustinvest therefore follows the established path in addressing first the requirements of the Trustee Act and the common law; then the tax treatment of the main types of trust; then the tax treatment of alternative investment vehicles; and then relating the tax treatment of investment vehicles to the tax treatment of the two main categories of trust.

Unless otherwise stated, all references are to English Law.

An excellent source of up-date information and technical discussion is the Society of Trust and Estate Practitioners' on-line Forum which can be accessed by STEP members and non-members alike via **trustsdiscussionforum.co.uk**.

About Prudential

Prudential manage the long-term savings of millions of people in the UK and across Europe and our customers include individual savers and investors, life insurance policyholders and pension schemes members.

We take the needs of financial advisers and their teams seriously. We provide service and support to help make your professional life easier and meet the financial goals of your clients. We are committed to maintaining our strong financial performance, to provide your customers with financial security and the chance to build a better future for themselves and their families.

We want to help and support you, and your professional connections, which is why our technical experts work alongside SIFA Professional on the TrustInvest Handbook.

PruAdviser is Prudential's website for UK financial advisers and their teams. It aims to give you the answers you need, keep you up to date on regulatory changes, help you do business online and much more. For more information please visit **pruadviser.co.uk**.

B. Law and Regulation Relating to Trusts

B.1 Types of Trust

A trust is not a legal person, instead it is a legal relationship which is created when a person (the 'settlor') transfers assets (property, shares or cash) to other people or to a trust company ('the trustees') with instructions that they hold the assets for the benefit of an individual or group of individuals ('the beneficiaries'). The unique feature of a trust is the separation of ownership of the trust assets: the trustees are the legal owners, while the beneficiaries have beneficial rights of enjoyment.

Trusts which are made during the lifetime of the settlor are known as inter vivos trusts, and will take effect immediately. In contrast, where a trust is created by will, it only comes into operation on death meaning that the settlor can change the terms prior to death. The trust deed or will states who the trustees and beneficiaries are to be, lays down the terms of the trustees' appointment, and contains all the other terms of the trust, including the powers of the trustees.

Note also that in England and Wales, where a person dies intestate in and leaves minor children then a statutory trust arises. In Scotland and Northern Ireland, a bare trust will arise. These aspects are covered later in the document.

From the point of view of the rights of beneficiaries, there are two main types of trust – those under which the beneficiaries have an enforceable ('vested') interest, and those under which they have only a prospective interest – and there are sub-categories of each of these types.

B.1.1 Vested interest trust type 1: Interest in Possession ('IIP') Trust

Although there is no statutory definition for tax purposes, an IIP trust is a trust under which a beneficiary has a right to receive the income from the trustees as and when it arises, or a right to the enjoyment of the trust assets. The right should be 'immediate'. If the trustees can withhold that right there will be no IIP. These trusts can take two forms:

B.1.1.1 Life interest Trust

This is a trust where one person (the 'life tenant') has a right to income for life or for a fixed period, and another or others (the 'remaindermen') are entitled to the capital on the death of the life tenant or the expiry of the fixed period. For example, "*on trust for my wife X for life, thereafter to my children A, B and C in equal shares absolutely*".

B.1.1.2 Flexible (or 'power of appointment') Trust

Prior to 22 March 2006, insurance companies commonly offered 'flexible' or 'power of appointment' IIP trusts under which the trustees have a power to appoint amongst, or to vary, beneficiaries. There are two classes of beneficiary – actual and potential with the trustees having the power to replace an actual beneficiary with anyone from the list of potential beneficiaries.

For example, "*on trust for such of my wife, children and remoter issue as the trustees shall from time to time by deed or deeds revocable or irrevocable at their absolute discretion appoint and in default of any appointment for my sons John and Jim in equal shares absolutely*".

A flexible IIP trust offered by an insurance company therefore allowed the settlor to choose named individuals (i.e. John & Jim) who were entitled to the income generated by the trust assets and allowed a discretionary class whereby the trustees could choose to allocate the capital to anyone in either class. Insurance company bonds were a common asset held within the trust due to the fact they do not produce income. A tax efficient flexible arrangement was therefore obtained.

22 March 2006 was the day of the 2006 Budget which made far reaching changes to the IHT treatment of trusts, many of which took immediate effect. As a consequence, new insurance policy trusts (other than bare trusts) created on or after 22 March 2006, even if expressed in terms of IIP trusts, are taxed under the relevant property regime.

B.1.2 Vested interest trust type 2: Bare or Absolute Trust

This is a trust where the beneficiary has an immediate and absolute right to both capital and income, which cannot be taken away – for example, "*on trust for X absolutely*". Trustee powers are therefore purely administrative. The trust can have more than one beneficiary provided that their entitlements are specified.

A bare trust would be created if an outright gift were made to a child – in a will or during lifetime – or if the child received compensation payments in respect of an injury which the parents must invest on the child's behalf. A common example of a bare trust is where an investment is made by a parent or grandparent for the irrevocable benefit of a minor child. This is tantamount to an outright gift, but, the trustees act as nominees until the child can give a valid receipt.

A bare trust can exist without a trust deed provided other information exists to support the trust's existence. With that in mind, does the designation of an investment for a minor constitute a bare trust? That depends on the paperwork. Is it clear that the donor has made an outright irrevocable gift? Is it clear that the trust fund has 'indefeasibly invested' in the child? Perhaps the safest course, if the intention is to create a bare trust, is to utilise formal trust documentation.

In its Trusts, Settlements and Estates Manual, HMRC state in TSEM1563.

"*It is up to the trustees to establish whether a trust is bare. If the trustees have access to legal advice they should ask their legal adviser whether the trust funds have 'indefeasibly vested' in the beneficiaries. If they have then the trust will be a 'bare trust'.*"

When the child reaches the age of 18 (or just 16 in Scotland), he or she can demand that the assets held in trust are transferred into his or her own name as absolute owner.

If the beneficiary dies, their share will pass under their will or intestacy.

The inflexibility of bare trusts means that they will not be appropriate when circumstances may change – for example when more children may be born, when there are second marriages, or when doubts exist as to the level of responsibility of young beneficiaries.

B.1.3 Non-vested interest trust type 1: Discretionary Trust

A discretionary trust is a power of appointment trust with no interest in possession – i.e. no actual beneficiaries, only potential ones. For example, "*for such of my children as the trustees shall in their discretion appoint by deed or deeds revocable or irrevocable*". The trustees (who may include the settlor) retain the flexibility to decide who should benefit from either capital or income, to what extent and when.

B.1.4 Non-vested interest trust type 2: Accumulation & Maintenance (A&M)Trust

An A&M trust is a form of discretionary trust which prior to 22 March 2006 enjoyed favourable IHT treatment subject to complying with certain conditions that beneficiaries should be the grandchildren of a common grandparent and should attain a vested interest in income and/ or capital by a specified age of not more than 25; or, if the beneficiaries did not meet the common grandparent test, that the trust had a life of no more than 25 years. The trust income, meanwhile, had to be accumulated or applied for the maintenance, education or benefit of a beneficiary.

Compliance with these conditions entitled transfers into A&M trusts during the lifetime of a settlor to be regarded as Potentially Exempt Transfers for inheritance tax purposes. A&M trusts were commonly used by grandparents and parents to set aside funds for the benefit of the young. This favourable tax treatment, which was not available to other forms of discretionary trust, was withdrawn with effect from 22 March 2006 and all gifts into such trusts are now treated as chargeable transfers and thus potentially liable to entry, ten year periodic and exit charges (see C.4.1 below).

Since 22 March 2006, there has been little point in creating new A&M trusts. Settlors will invariably opt for the greater flexibility provided by discretionary trusts.

B.1.5.1Trusts for vulnerable people

The Finance Act 2005 (Sections 23 to 45) introduced a new regime for certain trusts with vulnerable beneficiaries, which took effect from 6 April 2004. The broad aim of the special tax treatment was to protect trusts with vulnerable beneficiaries from the increase in the special trusts rate and the dividend trust rate that occurred on the same date.

The regime operates by ensuring that the amount of tax charged on income and gains arising to the trustees is no more than it would have been had the income and gains arisen directly to the vulnerable person.

Income tax and capital gains tax (CGT)

The special tax treatment applies to both income tax and CGT. A trust doesn't qualify for special income tax treatment if the person setting it up can benefit from the trust income. It would however qualify for special capital gains tax treatment.

Trustees may make a claim for special tax treatment for a tax year if the following conditions are satisfied:

- there is a beneficiary who falls within the definition of a vulnerable person
- the trustees hold property on 'qualifying trusts' for that beneficiary and
- a vulnerable person election has effect for all or part of that tax year.

Where there is more than one beneficiary, the property for the vulnerable person must be held in a specific fund or other part of the settled property for the benefit of that person.

For income tax, where a valid claim has been made, the trustees are entitled to a deduction of tax against the amount they would otherwise pay so that the final amount payable by the trustees is based on the particular tax circumstances of the vulnerable person. The trustees therefore calculate what their tax liability on the qualifying trusts income would be without a claim for special treatment, and then what the vulnerable person's tax liability would be on the qualifying trust's income if that income were to have arisen directly to him or her, taking into account his or her other income, and certain allowances. The trustees then claim the difference between these two figures as a deduction from their own income tax liability.

There is a similar situation with CGT. The trustees calculate what CGT they would normally pay. They then calculate what the beneficiary would have to pay if the gains had arisen directly to the vulnerable person.

The trustees then claim the difference between these two amounts as a reduction on their CGT liability.

A vulnerable person is either a disabled person or a relevant minor (more commonly referred to as a bereaved minor). For the purposes of the regime, a disabled person is either:

- a person unable to administer his or her property or manage his or her affairs because of mental disorder within the meaning of the Mental Health Act 1983, or
- a person in receipt of any of the following
  - attendance allowance
  - disability living allowance, by virtue of entitlement to the care component at the highest or middle rate, or the mobility component at the highest rate
  - personal independence payment
  - an increased disablement pension
  - constant attendance allowance
  - armed forces independence payment

A bereaved minor is a child under the age of 18 at least one of whose parents has died. When we refer to a "parent" we can include a step-parent or a person who, immediately before their death, had parental responsibility for the minor. In rare circumstances, a bereaved minor trust can be set up if a grandparent dies intestate e.g. A dies intestate in England & Wales and her adult child, B, pre-deceased and also died intestate. If for example there are two minor grandchildren (C and D) who will benefit under intestacy, they will be the beneficiaries of B's share of A's estate. While C and D are under 18, the trust will qualify as a trust for a bereaved minor.

A trust for a disabled person will be a qualifying trust for income tax and CGT purposes if it meets both the conditions below. The terms of the trust must ensure that the conditions will be met during the lifetime of the disabled person or until the termination of those trusts, if earlier.

The conditions are that

- the property can be applied for the benefit of the disabled person, and
- either the disabled person is entitled to all the income arising from the property or, if the disabled person is not entitled to all of it (i.e. there is no interest in possession), none of the income can be applied for the benefit of anyone else.

If the trustees have the powers, up to £3,000, or 3% of the trust capital, if lower, may be advanced to beneficiaries who are not disabled.

Where there is not just a disabled beneficiary, property held for the benefit of that disabled person must be 'ring fenced'. HMRC state that a ring-fenced fund within a trust is not a separate trust for tax purposes.

In the case of a bereaved minor, qualifying trusts fall into three categories

- statutory trusts established under sections 46 and 47 of the Administration of Estates Act 1925 for the bereaved minor, or
- trusts established under the will of a deceased parent of the bereaved minor or
- The Criminal Injuries Compensation Scheme where certain conditions apply

Inheritance Tax

Discretionary trusts are usually subject to the 10 year IHT charging regime but trusts with disabled beneficiaries are exempt if they conform with S89 IHTA 1984.

Since 1981, property transferred into a discretionary trust primarily for the benefit of a disabled person is treated for IHT purposes as if the disabled person had an interest in possession in the property. This means that transfers into trust will be treated as potentially exempt transfers (PETs) although self-settlements are not chargeable to IHT given that the property is treated as remaining in the settlor's estate. Distributions out of trust to the disabled person are not taxable, but an IHT liability may arise on death since the trust fund will form part of the beneficiary's estate.

- For a disabled person whose trust was set up before 17 July 2013 – at least half of the payments from the trust must go to the disabled person during their lifetime
- For a disabled person whose trust was set up on or after 17 July 2013 – all payments must go to the disabled person, except for up to £3,000 per year (or 3% of the assets, if that's lower), which can be used for someone else's benefit

The definition of a disabled person and relevant legislation is contained in S89 IHTA 1984.

In addition, consider a trust created under the terms of someone's will. That trust will not fall under the relevant property regime if it is a trust for a bereaved minor. When attaining 18, or before, the child must become absolutely entitled to the trust fund. Also, in England & Wales, a trust for a bereaved minor can arise through intestacy of a deceased parent. While the trust is in existence no discretionary trust charges arise i.e. no ten year anniversary or exit charges. So, none when the minor receives absolute ownership, and none when funds are used for the minor's benefit. There is also no IHT charge where the bereaved minor dies before reaching 18.

The intestacy rules in Scotland & Northern Ireland are different, and where trusts are established for children who have lost a parent, the terms of those trusts will be such that they will be treated as bare trusts for tax purposes.

Finance Act 2006 introduced a further category of "age 18-to-25 trusts". The provisions are similar to those applying to a trust for a bereaved minor but a trust cannot be an age 18-to-25 trust if it falls within the definition of a trust for a bereaved minor. A trust for a bereaved child (not grandchild) can be set up in the will as an 18 to 25 trust. Just like a bereaved minor's trust, creation of the trust is a chargeable death transfer. Basically what you're doing is simply delaying the age that a child of the deceased can inherit, to age 25, or earlier.

Again, the IHT 10-year anniversary charge doesn't apply. However, the main differences are

- The beneficiary must become fully entitled to the assets in the trust by the age of 25
- When the beneficiary is aged between 18 and 25, IHT exit charges may apply but only if the trust fund exceeds the Nil Rate Band available to the trustees

The exit charge will be a fraction of 6%, with the amount depending on how long after the age of 18 the payment is made. For example, if the child inherits at age 21 the inheritance tax rate will be 3/10ths of 6% = 1.8%. If the child inherits at age 25 the maximum IHT rate will be 7/10ths of 6% = 4.2%.

B.1.5.2 Statutory Trusts

A trust which is created by statute is called a statutory trust. For example consider an individual who dies intestate in England and Wales and is survived by a spouse and minor children. Assume the estate is valued at £770,000. In that case, the surviving spouse will receive £270,000, and £500,000 is then shared as follows.

- The surviving spouse gets an absolute interest in half of £500,000
- The other half is then divided equally between the surviving children and held in a statutory trust until they attain the age of majority.

Another example of a statutory trust arises under the Married Women's Property Act 1882 ('MWPA'). This provides for a policy to be written on the policyholder's own life, for the benefit of spouse and/or children, whereby the policy proceeds will not form part of the estate of the life assured or be subject to their debts.

B.1.6 Non-resident trusts

The UK concept of a trust is not universally recognised overseas.

An non-resident trust is defined for UK income tax and capital gains tax purposes as one in which either all the trustees are non-UK resident or, if some of the trustees are UK resident, the settlor was non-UK resident, not normally resident or non-UK domiciled at the time the trust was created or funds added.

B.2 Trustees' Statutory Powers And Duties

B.2.1 Powers of investment

Trustees' investment powers are prescribed by statute, or by the wording of the trust deed, or by a combination of the two.

Prior to the passing of the Trustee Act 2000 ('the Act'), trustees whose trust deed did not permit wider investment powers were subject to the restrictions imposed by the Trustee Investments Act 1961, which required that not less than 25%

(originally 50%) of a trust's funds should be invested in 'narrower range' investments, comprising essentially gilts, cash and debentures, and not more than 75% in a prescribed list of "wider range" investments.

Happily, these restrictions were swept away by the Act, s3 of which permits a trustee to: *"make any kind of investment that he could make if he were absolutely entitled to the assets of the trust"*.

This 'general power of investment', which applies to all trusts, whenever created, is a default power, additional to any other powers conferred on trustees, but subject to any restriction or exclusion imposed by the trust instrument. It permits trustees to invest in assets which may be expected to produce either an income or capital return, in the same way as if they owned on their own account the assets which they hold in trust. Being able to invest in non-income producing assets such as insurance bonds, gives them the power, which could previously only be conferred by the trust deed. The only investments denied to trustees are those whose terms of issue confine them to private individuals investing in their own capacity, such as Individual Savings Accounts.

There are, however, a number of safeguards to ensure that the general power of investment is exercised responsibly. Firstly, Trustees remain subject to their fundamental duties to act in the best interests of present and future beneficiaries and to avoid any conflict between their duties as trustees and their personal interests.

Secondly, s1 of the Act requires trustees to exercise reasonable skill and care. Thirdly, s4 of the Act requires trustees to have regard to *"standard investment criteria"* and to review investments from time to time and consider whether, having regard to the standard investment criteria, they should be varied. Also, s5 requires trustees to take *"proper"* advice on investment.

B.2.1.1 s1 Trustee Act 2000: The duty of care

In determining what is reasonable skill and care, a subjective test is applied which can take account of the particular knowledge, experience and professional status of the individual trustee. So higher standards will be expected of investment professionals, acting in their capacity as such, than of lay persons.

B.2.1.2 s4(1) and s4(3) Trustee Act 2000: The standard investment criteria

In exercising any power of investment, a trustee must have regard to the standard investment criteria.

The standard investment criteria, in relation to a trust, are: "(a) *the suitability to the trust of investments*...and

(b) *the need for diversification*..."

The duty placed on trustees to ensure the suitability of investments corresponds to the duty placed on financial advisers, and relates both to the type of investment proposed and to the features of the particular investment being considered, including its tax treatment. As a component of suitability, express account must be taken of the size and risk profile of the investment. When advising private clients, financial advisers would assess their personal attitude to risk, but personal attitudes are not relevant when individuals are acting as trustees.

With regard to diversification, the trustees must consider the need for diversification in so far as is appropriate to the circumstances of the trust.

B.2.1.3 s4(2) Trustee Act 2000: Keeping investments under review

The requirement that trustees should keep investments under review codifies the common law position, under which "a trustee with a power of investment must undertake periodic reviews of the investments held by the trust" (Nestlé v National Westminster Bank – see B.3.3 below).

S4(2) provides that "*a trustee must from time to time review the investments of the trust and consider whether, having regard to the standard investment criteria, they should be varied.*" The extent of this duty was the subject of the case of Gregson v HAE Trustees Ltd and Others [2008] EWHC 1006 (Ch) and [2008] WLR (D) 146. The trustees argued that their duty to review should be regarded as being confined to investments which they had bought in the exercise of their powers of investment. However, the judge held that it extended to all property of the trust and there was nothing in the statutory wording to suggest that it should not include investments which were part of the original settlement.

Delegating the management of trust investments to third party professionals does not absolve trustees of responsibility. They have an on-going duty to monitor the performance of the professional manager.

If a trust investment consisted of a large or controlling share in a company, the trustees would have a duty to do more than simply review performance. They would be expected to utilise their position to ensure that the company was being run in a manner which would safeguard the value of their investment.

The case in point is Bartlett v Barclays Bank (Nos. 1 and 2); ChD 1980, in which Brightman J said "*The bank, as trustee, was bound to act in relation to the shares and to the controlling position which they conferred, in the same manner as a prudent man of business. The prudent man of business will act in such manner as is necessary to safeguard his investment. He will do this in two ways. If facts come to his knowledge which tell him that the company's affairs are not being conducted as they should be, or which put him on enquiry, he will take appropriate action. What the prudent man of business will not do is to content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at annual general meetings. Since he has the power to do so, he will go further and see that he has sufficient information to enable him to make a responsible decision from time to time either to let matters proceed as they are proceeding, or to intervene if he is dissatisfied.*"

In order to limit the degree of responsibility which this precedent might be taken to impose on trustees who are unlikely to be expert in the affairs of investee companies, 'anti-Bartlett' clauses have been become commonplace in Trust deeds, which modify the obligation to supervise and enquire.

B.2.1.4 s5 Trustee Act 2000: Taking advice

Section 5 of the Act requires trustees, when considering the exercise of a power of investment or carrying out a review of the investments of the trust, to obtain and consider proper advice, so as to ensure that account is taken of the standard investment criteria. An exception is permitted in circumstances where the trustees consider that taking advice would be unnecessary or inappropriate – e.g. where the investment is so small that the cost of advice would be disproportionate or where the trustees themselves possess relevant investment skills.

"*Proper advice*" is defined as meaning:

"*the advice of a person who is reasonably believed by the trustee to be qualified to give it by his ability in and practical experience of financial and other matters relating to the proposed investment*".

B.2.2 Power to apply income for the benefit of child beneficiaries

If it has not been excluded by the trust deed, S31 of the Trustee Act 1925 gives trustees discretion as they think fit, to apply the whole or part of the income of a trust for the maintenance, education or benefit of an under 18 beneficiary. When they do so they must act in a proper manner, routing income payments where appropriate through children's parents or guardians. The trustees must then accumulate the residue of that income and add it to the capital of the trust fund. This discretion ends when the beneficiary attains 18, and until he/she obtains a vested interest, the trustees must pay all the income to the beneficiary. Trustees must also take account of tax considerations when investing for trusts where the settlor is the parent of the beneficiary. The Act does not apply to trusts administered in Scotland or established under Scots law.

B.2.3 Power to advance capital

Under s32 of the Trustee Act 1925, trustees have a statutory power to advance capital to "*any person entitled to the capital of the trust property or of any share thereof*". Most modern trusts incorporate specific wider powers. In the Inheritance & Trustees' Powers Act 2014, S32 was modified such that advancement of capital can also be made by a transfer of assets (i.e. not cash alone) – this change applies to all trusts whenever created. In addition, trustees can now advance up to the whole of a beneficiary's presumptive share and this power applies to trusts established after these new provisions came into force, subject to any express provisions in the trust document.
If there are no express provisions, this will mean that trustees are not restricted regarding capital advances.

An alternative to advancing capital is for trustees to make loans to beneficiaries. A future write-off of the entire loan or a part of it would qualify as a capital distribution.

It should be remembered that Finance Act 2013 introduced restrictions on the deductibility of loans in inheritance tax calculations.

B.2.4 Power to delegate

An important innovation introduced by the Trustee Act 2000 was to empower trustees (in s11) to collectively delegate to agents (e.g. an estate agent to sell a property) any of their functions except certain defined responsibilities such as decisions as to the distribution of assets; as to whether fees should be paid out of income or capital; and as to the appointment of new trustees.

The power to delegate includes the power to appoint nominees (s16) and custodians (s17), provided that the appointees carry on business as such or are a body controlled by the trustees, and provided that the appointment is evidenced in writing. Nominees will have their name on the legal title to trust assets whereas custodians look after the trust assets, Also, trustees can delegate discretions relating to asset management such as discretionary management services. S15 sets out the necessary conditions for appointment of a Discretionary Fund Manager (DFM).

(1) The trustees may not authorise a person to exercise any of their asset management functions as their agent except by an agreement which is in or evidenced in writing.

(2) The trustees may not authorise a person to exercise any of their asset management functions as their agent unless … they have prepared a statement that gives guidance as to how the functions should be exercised (‘a policy statement’)

(3) The trustees must formulate any guidance given in the policy statement with a view to ensuring that the functions will be exercised in the best interests of the trust.

(4) The policy statement must be in or evidenced in writing.”

A DFM's policy statement would typically cover the following:

- The objectives of the trust
- Income and growth requirements
- Whether capital might be distributed in place of income
- Anticipated capital additions and/or withdrawals
- Liquidity requirements
- The approach to risk
- The investment strategy
- The time horizon
- The day to day management of investments
- The residence and tax status of the trust and beneficiaries
- Any restrictions or constraints on investment (e.g. ethical)
- Any tax or legal constraints
- The base currency
- The investment benchmarks
- Review periods.

The DFM service has the advantage over an advisory service that DFMs do not need to obtain clients' approval before entering into transactions on their behalf. This means that they can switch investments swiftly in response to movements in the stock market and implement changes across all the portfolios for which they are responsible with minimal administrative cost. However, DFMs tend to be selective as to the size of the portfolios for which they will undertake responsibility.

Also, their role is confined to investment and they do not provide the financial planning overview which takes account of clients' tax and personal financial situations. This is the role of the financial adviser who instead of providing a policy statement will conduct a factfinding exercise, using a pro-forma such as that shown as Precedent 2. When a financial adviser is interposed between the client and the DFM, the financial adviser will provide direction to the DFM, based on knowledge of the financial planning context within which the investment services are conducted, and will maintain an on-going relationship with the client.

B.2.5 Power to insure

s34 of the Act empowers trustees (other than bare trustees) to insure any property which is subject to the trust against risks of loss or damage, as if the property were their own, and to pay the premiums out of the trust funds.

B.2.6 Powers to be exercised by unanimous decision

All trustees' decisions must be unanimous unless the trust deed provides to the contrary. Powers must be exercised jointly. Under Scots law, trustees can act by majority unless the trust deed states otherwise.

B.2.7 Modification of powers conferred by the Trust Deed

If trustees wish to seek an extension of their powers beyond those conferred by the trust deed, there are two ways of achieving this. Either the beneficiaries, subject to all being of full age and sound mind, can consent in writing; or in more complicated situations, application can be made to the Court under the Variation of Trusts Act 1958 to sanction a variation in the terms of the trust – though this will involve expense.

B.3 Trustees' Common Law Responsibilities

Trustees' overarching responsibility is "to *preserve and safeguard trust property*" (Lewin on Trusts, Chapter 34). The specific responsibilities are as follows:

B.3.1 Duty to ensure that investments are suitable

In the 1886 case of Whiteley, the court expressed trustees' duties in relation to investment as being to take "*such care as a prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide*". In this case, emphasis was placed on the importance of protecting and maintaining the trust; and the case of Target Holdings v Redferns [1996] 1AC 421 is authority for the proposition that trustees (in this case a solicitor trustee) will be liable for breach of trust in the event of unsuitable investments causing loss to the trust.

The High Court adopted a balanced approach in Nestlé v National Westminster Bank in 1990 (see B.3.2 below), confirming the view that trustees might normally be expected to invest predominantly in equities but noting with approval the suggestion in an earlier case that failure to diversify into fixed interest securities might potentially amount to a breach of trust. Hoffmann J concluded that risk should be broadly spread and implied that the main building blocks are likely to be equities and fixed interest securities. However, investment techniques have moved on since these remarks were made, and it seems likely that wider diversification and greater use of collective investments would now be commended.

Trustees must not allow their own political, social or moral views to influence their judgment as to what is in the best interests of beneficiaries. The case in point here is Cowan v Scargill [1984] 1 Ch 270 in which it was held that it was inappropriate for certain trustees of the Mineworkers' Pension Scheme to let their political views affect the investment policy of the fund. Taking the principle to a logical conclusion, it might also be argued that it would be inappropriate for trustees to favour ethical investments on the basis of their personal moral stance.

Given that trustees should be seeking to maximise returns consistent with commercial prudence, then how should they approach Environmental, Social, and Corporate Governance (ESG) funds? Clearly it is problematic if investment performance is poor even if the investment has a positive ESG impact. Beneficiaries might be reluctant to focus on the ESG benefits when their income/capital has been adversely affected. But, the contrary view might be that such an approach reduces risk and leads, potentially, to improved long term returns. Perhaps, driven by 'environmentally conscious' settlors, we will increasingly encounter provisions in trust deeds expressly including the power to make ESG investments. In E.4, charities are considered. A government investment guide for charities (CC14) states that when considering which companies and organisations to invest in, charities are increasingly taking into account such factors as impact on climate, employment practices, sustainability, human rights, community impact, executive compensation and board accountability. These are all examples of ESG risk areas which can have long term impacts and can affect the value of a company's shares positively or negatively depending on how the risk areas are managed. In any event, ESG investing is here to stay and is increasingly becoming a market standard from investment houses to integrate the financial implications of ESG factors into their investment processes. It is considered that the integration of ESG factors into investment decisions can help better manage risks and generate sustainable long term returns for investors.

Duty to take account of settlors' wishes

Trustees must consider the scope of their investment powers under the Trustee Act or the Trust Deed, and how these are best exercised to achieve the objectives of the trust.

A settlor may sometimes write a side letter to the trustees, containing an expression of wishes. This would not be binding on the trustees, but would stand alongside the trust document and provide guidance to the trustees as to the way in which the settlor would like them to carry out their duties. For example, a discretionary trust might typically have a wide range of beneficiaries, but the settlor might wish particular preference to be given to one or more individuals.

However, trustees would not be permitted to rely on expressions of wishes in any dispute with beneficiaries as to the exercise of their discretion. Letters of wishes are personal to trustees and usually confidential but could be disclosed to beneficiaries if the trustees consider this to be in the interests of the trust.

B.3.2 Duty to ensure fairness between beneficiaries

Trustees must hold the balance fairly between different categories of beneficiary. For example, if a trust provides that one class of beneficiary (the life tenant) is to receive income from the trust fund during their life and a second class (the remaindermen) is to receive capital on the death of the life tenant, it would be unfair to the life tenant if the trustees were to invest in assets which produced little or no income, but offered the prospect of greater than usual capital growth. Equally, it would be unfair to the remaindermen if the trustees were to make investments which offered a high income but little or no capital growth, or which led to the value of the capital being eroded. The exception might be if the settlor made it clear that one class of beneficiary was to be preferred over another.

Cotton LJ summarised the requirement in Re Whiteley [1886] 33 Ch D 347: *"Trustees are bound to preserve the money for those entitled to the corpus in remainder and they are bound to invest it in such a way as it will produce a reasonable income for those enjoying the income for the present"*.

Nestlé v NatWest [1993] 1 WLR 1260 is the leading case on the subject. The final judgment was given in the Court of Appeal on appeal from the High Court. The nub of the case was the remainderman's contention that the trust fund to which she became entitled would have been worth almost four times as much if it had been invested more suitably. The trustees had mistakenly assumed that their investment powers were more limited than was actually the case, and had compounded the error by failing to undertake sufficiently regular reviews of the portfolio. In the event, it was held on appeal that the remainderman had been unable to prove that the trustees' shortcomings had caused loss, and that she was therefore not entitled to any compensation. However, some important light was cast on trustees' responsibilities. In the words of Mr Justice Hoffmann in the High Court (per The Times Law Report, 1990):

"The trustee must act fairly in making investment decisions which may have different consequences for different classes of beneficiaries. There are two reasons why I prefer this formulation to the traditional image of holding the scales equally between tenant for life and remainderman. The first is that the image of the scales suggests a weighing of known quantities whereas investment decisions are concerned with predictions of the future. Investments will carry current expectations of their future income yield and capital appreciation and these expectations will be reflected in their current market price, but there is always a greater or lesser risk that the outcome will deviate from those expectations.

A judgment on the fairness of the choices made by the trustees must have regard to these imponderables. The second reason is that the image of the scales suggests a more mechanistic process than I believe the law requires.

The trustees have in my judgment a wide discretion. They are, for example, entitled to take into account the income needs of the tenant for life or the fact that the tenant for life was a person known to the settlor and a primary object of the trust whereas the remainderman is a remoter relative or a stranger. Of course these cannot be allowed to become the over-riding considerations but the concept of fairness between classes of beneficiaries does not require them to be excluded. It would be an inhuman law which required trustees to adhere to some mechanical rule for preserving the real value of the capital when the tenant for life was the testator's widow who had fallen upon hard times and the remainderman was young and well off".

In Re Mulligan (Deceased) [1998] 1 NZLR 481 the New Zealand High Court held that the discharge of a trustee's duty to act with due diligence and prudence was flexible and changed with economic conditions and contemporary thinking and was therefore judged applying the standards of the relevant period. A trustee had to be strictly impartial and even-handed between income and capital beneficiaries in the circumstances of the case (including those of the beneficiaries). The trustees invested in fixed-interest securities to benefit the deceased's widow (the income beneficiary) to the detriment of the capital beneficiaries. The trustees were in breach of trust because the trust company officers all recognised the corrosive harm of inflation to the estate capital (which was reliable evidence of the standard of prudence in the industry at the time) and should have attempted to persuade the widow by explaining trustees' duty to be even-handed or applied to the Court for directions rather than deferring to her wishes that they invest for income, particularly given her self-evident conflict of interest and preoccupation with maximising income from the estate.

The question of fairness was also at issue in a case which came before the Financial Services Ombudsman in 2000. Here, the trustee of a pension scheme was the employing company and the scheme was insured with Scottish Widows. Benefits were secured by policies in the names of individual members. One of the scheme members, Mr Crutchfield, was blamed for a down-turn in the company's trading and was made redundant. Subsequently the trustees received compensation on the de-mutualisation of Scottish Widows and asked the company to omit Mr Crutchfield from participation in the compensation payment. They explained to the Ombudsman that they had done this because they wished to penalise Mr Crutchfield for his management shortcomings, but the Ombudsman ruled that they must exercise their discretionary powers fairly and not permit themselves to be swayed by any ulterior motive.

B.3.3 Duty to monitor investments

A ruling of the Financial Services Ombudsman in 2000, although it does not establish a legal precedent, provides a helpful reminder that in addition to monitoring investments, trustees should ensure as a matter of good practice that beneficiaries are kept in the picture. In this case, the trustees had arranged an 'AVC' (additional voluntary contribution) pension scheme through which contributions were invested in a Northern Rock deposit account. Between 1998 and 1999 Northern Rock's interest rates became uncompetitive and the member, a Mrs Lambeth, complained that her policy had lost value. The Ombudsman found that the trustees had in fact switched to a different provider within a reasonable period of time, but that they had been guilty of maladministration in failing to inform Mrs Lambeth of her right to withdraw from the scheme.

B.3.4 Duty not to sit on cash

Lewin on Trusts states in Chapter 35 “*Trustees are under a duty to make the trust fund productive for their beneficiaries by investing it” – and “investment*” was defined in Re Wragg [1919] 2 Ch 58, p65 as being the application of money “*in the purchase of some property from which interest or profit is expected and which is purchased for the sake of the income it will yield*”.

The court in Re Power [1974] Ch 572 held that current accounts and property which is purchased for occupation by a beneficiary should be excluded from the requirement to invest. However, where material amounts of cash are held, trustees should normally consider investing this unless it is required for use by a beneficiary in the very near future.

In Midland Bank Trustees (Jersey) Limited v Federated Pensions Services Ltd [1996] Pensions Law Reports 179 it was held that trustees who had kept trust monies on deposit for three months were in breach of trust because they had failed to take advantage of a rising market. This reflected the view of the court in Nestlé v NatWest, in which it was held that, in view of the lengthy investment period involved, at least half of a trust fund held for persons in succession, with vested interests, should have been invested directly or indirectly in equities.

B.3.5 Duty to take account of tax considerations

When choosing between alternative types of investment, trustees must take account of characteristics impacting tax and cost efficiency; and a portfolio which is structured to mitigate tax will need to be reviewed in the light of periodic changes in the tax rules.

The Court made clear in Nestlé v NatWest that consideration must also be given to the tax status of the beneficiaries. Consequently, in circumstances where a tenant for life was non-resident, trustees would be entitled to purchase investments which would not be subject to deduction of income tax at source or to capital taxes on death. They could also take account of the relative wealth of the life tenant and the remainderman when deciding whether to invest in high-income or low-income investments.

Failure to take account of tax considerations was also the issue in the case of Hurlingham Estates Limited v Wilde and Partners [1997] STC 627, which was not itself a trust case but which underlined the responsibilities incumbent on professionals. Here, a solicitor stepped out of his area of expertise in residential conveyancing by giving advice on a commercial property transaction, but failed to appreciate the complexities of an unfamiliar tax regime. The court held that as a professional he was expected to be aware of and to alert clients to tax considerations impacting his advice. The judge said: "*The test to be derived from the authorities is whether, having regard to the terms of his retainer, in all the circumstances which were known or should have been known (to the solicitor, he) should reasonably have appreciated that Hurlingham needed his advice and guidance in respect of the tax liabilities to which entry into the transaction would expose it*".

B.3.6 Conflicts of interest

Conflicts of interest can arise in relation to family trusts where the trustees are also beneficiaries. Trustees are only permitted to apply trust assets for their own benefit in situations where either the trust instrument disapplies the prohibition against 'self-dealing' either expressly or impliedly (Edge v Pensions Ombudsman [2000] Ch 602) or the trustees are given the power by the settlor to make dispositions in their own favour. For the avoidance of doubt, it is not uncommon for a person to be both a trustee and a beneficiary.

B.3.7 Removal of trustees

If the deed contains relevant powers, then that is the simplest route. For example, the deed may state that while living and of full mental capacity, the settlor may dismiss by deed any trustee… If the deed doesn't help, s36 of the Trustee Act 1926 can assist the other trustees in certain defined circumstances without going to court (e.g. a trustee who has died or a trustee who has remained outside the UK for more than 12 months can be removed). The position is not always so cut and dried though. For example, s36 covers trustees who are "unfit to act" , but clearly that can be very subjective unless for example the trustee has committed fraud.

Also, the Courts have the power to remove a trustee – see s41 of the Trustee Act 1925.

B.3.8 Disclosure of information to beneficiaries

Trustees are under a duty to account for their actions to beneficiaries. This follows from the essential requirement that the trustees must act and deal with the trust fund in the interests of the beneficiaries.

Beneficiaries are entitled to know of their status and are entitled to see the trustee accounts.

Beneficiaries are entitled to a copy of the trust deed and supplementary documents (e.g. deeds of appointment).

B.4 Trustees' Remuneration and Expenses

B.4.1 The right of professional trustees to be remunerated

Section 28 of the Trustee Act 2000 reversed the common law rule which previously prevented professional trustees from making any personal gain in exercising their powers. It provides that a trustee is entitled to payment in respect of services rendered, even if these services were capable of being provided by a lay trustee, provided that:

- there is provision in the trust instrument permitting the payment
- the trustee is a trust corporation or acting in a professional capacity and
- the application of s28 is not inconsistent with the terms of the trust instrument.

B.4.2 Expenses

The general rule laid down in Carver v Duncan [1985] STC 356 is that *"income must bear all ordinary outgoings of a recurrent nature"* – which includes expenses properly incurred in managing a trust. In that case, the premiums on a term policy taken out to protect the trust capital in the event of the settlor's death were held to be a capital expense.

The same principle was reiterated in the 2007 case of Peter Clay Discretionary Trust v HMRC, in which the Special Commissioners concluded that the charge should only be to capital if the expense is essentially a capital expense and the financial interest of the income beneficiary is confined to the loss of income on the capital which goes to pay the expense.

Expenses are not deductible for basic rate tax purposes, but can be deducted when calculating any additional rate tax payable by the trustees, i.e. the difference between basic rate and the Rate Applicable to Trusts ('RAT' – see C.1).

The order of set-off of expenses is as follows:-

(i) against dividend income

(ii) against interest

(iii) against other income.

B.5 Referrals to Financial Advisers

B.5.1 SRA Code of Conduct

The revised Solicitors Regulation Authority Standards and Regulations of 2019 anticipate a more structured approach, with the introduction of a Firm Code of Conduct, for the first time, alongside the individual code. Whilst the overriding principle of always acting in a client's best interests is crucial when it comes to referrals the new rules expect a solicitor firm's management, and this is prescribed primarily to the Compliance Officer for Legal Practice (COLP), to install firm-wide systems and processes to give third party referral structure.

When there is a financial interest for the solicitor in making the referral to a financial adviser third party, it must not only be demonstrably in the client's best interests, but the client must give their informed consent to the referral. The SRA does not prescribe how this is recorded but suggests a signature to acknowledge acceptance of the referral or a recorded phone call. Where there is no financial interest the informed consent is not a requirement but with GDPR often applying and where clients of solicitors might frequently be deemed vulnerable, it is certainly acknowledged as best practice.

One further point of note is that another of the Standard and Regulations overriding principles is that of always acting with independence. In this field the SRA cautions that if a solicitor always is seen to be referring to the same third-party, this may come under scrutiny. Therefore, selecting a preferred list or panel of financial advisory firms based on specialisms is recommended.

B.5.2 Due diligence audit trail

Given the new SRA approach, adopted in November 2019, more than ever it is essential that firms have an established formal procedure for referrals. The COLP now has the responsibility within the Firm Code of Conduct to ensure that this is understood and applied by all members of the firm and reviewed on a regular basis. To do so, logically COLPs will need to have conducted due diligence on the selected financial adviser partners, to be satisfied that they are appropriate referees for the type of work their solicitors will need to refer.

Financial adviser firms which are members of SIFA Professional will understand this and will provide 'About us' statements describing their business specialisations, the qualifications and accreditations of their advisers and their investment proposition. Crucially this should include which areas of the financial planning process they will need to be referring clients back to the solicitor. Best practice suggests a law firm should make this due diligence and research on the chosen financial advisory firms available to their solicitors, so they can explain to their client, with evidence why they deem the referral to be in their best interests.

Precedent 2 is a fact find document of the sort which a financial adviser would need to complete before advising on trust investment. This is an abbreviated version of Precedent 1, which is a more comprehensive document designed for use by professional trustees. Precedent 3 is a suggested form of report by the financial adviser to the instructing solicitor after having reviewed a referred trust case.

B.6 UK Law Outside of England & Wales

The Charities and Trustee Investment (Scotland) Act 2005 gives Scottish trustees broadly similar investment powers to those enjoyed by English and Welsh trustees under the Trustee Act 2000.

The Scottish Act amends the Trusts (Scotland) Act 1921 and echoes the English Act by allowing trustees "to make any kind of investment of the trust estate". It provides that this power will override any restrictions contained in trust deeds executed before 3 August 1961 (the date on which the Trustee Investments Act 1961 was passed) and will also override any provisions in trusts established after 3 August 1961 which restrict trustees' powers to those contained in the 1961 Act.

As to trustees' duties, the same standard investment criteria of suitability and diversification apply as in England and Wales, as does the requirement to take proper investment advice from a person the trustees believe to be qualified by ability and practical experience, except in circumstances where the trustees reasonably conclude that in all the circumstances this is unnecessary or inappropriate.

As to the delegation of trustees' powers, s4B(1) of the Scottish Act provides:

"The trustees of a trust may… appoint a person to act as their nominee in relation to such of the trust estate… as they may determine"; and, following the English Act, section 4C provides:

"It is declared that the trustees of a trust have and have always had the power, subject to any restriction or exclusion imposed by or under the trust deed or any enactment, to authorise an agent to exercise any of their investment management functions at the agent's discretion or in such other manner as the trustees may direct".

However, in cases where trustees delegate their investment powers to a discretionary manager, there is no requirement under the Scottish legislation for an investment policy statement of the type required in England and Wales (see B.2.4 above), though in practice the policy will be incorporated in the two-way Agreement required by the FCA.

As regards Northern Ireland, the Trustee Act (Northern Ireland) 2001 mirrors the provisions of the English Act.

B.7 The Trust Registration Service (TRS)

Background

The TRS which became operational on 13 July 2017 provides a single online route for trusts (and complex estates) to comply with their registration obligations and to obtain their Self-Assessment (SA) Unique Taxpayer Reference (UTR). Trusts require a UTR in order to submit the

SA tax return. A complex estate is one that does not meet the conditions for using informal payment procedures.

Previously, HMRC required completion of paper Form 41G (Trust) to register a new trust and capture relevant information. Back then, HMRC stated "if there is no income arising, and no likelihood of income or gains in the future, you do not need to complete this form". This was a useful exclusion in situations where the trust fund simply comprised a non-income producing investment bond.

HMRC embraced the digital world when it recognised the UK government obligations under the 4th Money Laundering Directive (4MLD). Form 41G (Trust) was therefore withdrawn and instead trusts that are required to register, do so through the TRS. Things have moved on however and we now also have 5MLD to consider. With respect to 5MLD, the Government published regulations expanding the scope of the register. These came into force on 6 October 2020.

Trusts in place before the introduction of the TRS are also required to be registered because the new legislation expands the scope of information previously collected.

For the avoidance of doubt, these TRS obligations are unconnected to the obligations to complete IHT100 when lifetime transfers are made.

4MLD and 5MLD combined

To begin with, the TRS had a dual purpose under 4MLD. It gave rise to a central register containing beneficial ownership details for taxpaying express trusts, and it also served to notify HMRC of a tax liability. The information collected enables HMRC to set up a tax record for the trust, provide a UTR and issue a trust tax return where required. The beneficiaries are the beneficial owners.

What about 5MLD? Where a trust is already registered under 4MLD, some additional information is required to fulfil the requirements of 5MLD. Trustees will be required to access the updated TRS system, to do so. Where a newly registered trust has no liability to tax, the trustees will only need to provide information about the beneficial owners of the trust – settlors, trustees and beneficiaries – in line with 5MLD requirements.

Registration

Under 4MLD, 'Express' trusts with UK liabilities were required to register whether UK or non UK resident. From 6 October 2020, 5MLD widens the definition of trusts required to register.

The term "express trust" means a trust that was deliberately created by a settlor expressly transferring property to a trustee for a valid purpose, as opposed to a statutory, resulting or constructive trust.

The legal responsibility for registration lies with the trustees. With regard to professional advisers, the TRS requires the details of the agent (if one exists) registering on behalf of the trustees.

When a trust is registered for the first time, that is a new registration process. In later years the trustees will either just update the details of the existing registration or confirm that the details remain up to date and accurate.

Lead trustees

Trustees must nominate one 'lead' trustee to be the main point of contact for HMRC. The lead trustee will receive the trust's UTR and reminders to file a tax return. The TRS requires the lead trustee's (up to date) name, date of birth, National Insurance number and address (if UK), passport details and address (if non-UK), and telephone number. If the lead trustee is a corporate then company information is required.

Trusts that needed to register under 4MLD

An 'express trust' where the trustees have incurred a tax liability, in a given tax year, including these UK taxes

- Income Tax
- Capital Gains Tax
- Inheritance Tax
- Stamp Duty Land Tax
- Stamp Duty Reserve Tax and (in Scotland) Land and Buildings Transaction Tax

This wasn't always straightforward. Consider an IIP trust where the income had been mandated to the income beneficiary. In that case, the income was not received by the trustees, because it is was paid directly to the beneficiary meaning that the trustees had not incurred an income tax liability. And so, under 4MLD, no registration was required unless the trustees had incurred an income tax liability on other income, or they had incurred another tax liability.

Trusts that need to register under 5MLD from 6 October 2020

From 6 October 2020, new rules were introduced widening the scope of the TRS to all UK and some non-UK trusts, whether or not the trust has any UK tax to pay, but with some specific exclusions.

A. All UK express trusts need to register unless there is a specific exclusion (see below).

B. A non UK express trust (unless excluded) must be registered where there is at least one UK resident trustee when the trustees enter into a 'business relationship' with an 'obliged entity' expected to last for at least 12 months (e.g. a financial institution, accountant, legal professional etc.) or acquire land or property in the UK. Registration is also required where there are no UK resident trustees but the trust acquires land or property in the UK.

   5MLD requires that, when entering into a new business relationship with a trust, 'obliged entities' must collect either proof of registration on the trust register, or an excerpt of the register. An obliged entity could be a financial institution, and adviser, an accountant etc. The government proposes that the onus will be on the trustee to provide this information rather than the obliged entity having direct access to the register. This means the trustee has control over who sees the information. An insurance company accepting a trustee investment application would seem to be an 'obliged entity'.

C. Also needing to be registered are non-express trusts and excluded express trusts (see below) which have a tax liability – these trusts have to be registered on the TRS for SA purposes, even though they are not in scope under 5MLD.

Express Trusts that do not have to be registered

The government has provided an exclusion for those express trusts set up for a very limited purpose and which are very unlikely to be used for money laundering or terrorist financing because they are highly regulated or are registered elsewhere. For example, the following trusts are among those excluded from registration unless they are liable to pay tax.

- Trusts used to hold money or assets of a UK registered pension scheme, such as an occupational pension scheme
- Trusts used to hold a life or retirement policy paying out only on death, terminal or critical illness or permanent disablement, or a policy paying out to meet the cost of healthcare services.
- Will trusts which are created by someone's will and come into effect on their death providing the trustees only hold the estate assets for up to 2 years after the person's death.
- Charitable trusts which are registered as a charity in the UK or which are not required to register as a charity (for example, schools, museums, galleries, churches and certain groups)
- 'Pilot' trusts which were set up before 6 October 2020 for a future use and which hold no more than £100
- Co-ownership trusts set up to hold shares of property or other assets which are jointly owned by 2 or more people for themselves as 'tenants in common'
- Trusts for bereaved children under 18 or adults aged 18-25 set up under the will (or intestacy) of a deceased parent or the Criminal Injuries Compensation Scheme

In contrast to 4MLD, under 5MLD there is now no 'carve out' for Bare Trusts. There is also no carve out for trusts (bare and non-bare) holding a non-income producing investment bond. Perhaps that's just common sense? Although a trustee held bond didn't give rise to an immediate registration requirement under 4MLD, that maybe just delayed matters if the trustees later become liable to pay tax.

The position for non-express trusts

Those imposed by Courts or created by legislation, are not 'express trusts' and therefore do not have to register unless they are liable to tax. For example, a trust:

- set up under the intestacy laws
- set up under a Court Order to hold compensation payments
- to hold jointly owned assets, such as a home jointly owned with a spouse, partner or relation as 'joint tenants', or a joint bank account

For the avoidance of doubt, financial arrangements such as the Child Trust Fund or Venture Capital Trusts, are not really trusts and so do not have to be registered.

Information required by the TRS

When registering, trustees (or agents) must provide information about the trust and those associated with it. The level of detail depends on whether the trust is liable to tax or not and if it has already been registered.

Trusts which are not liable to tax

Basic information is required concerning the settlors, trustees and beneficiaries. For individuals this is name, date of birth, country of residence, nationality and role in the trust. For companies, this will comprise company name, address and role.

Trusts which are liable to tax

The above information is required plus additional information such as name of the trust, date it was set up, details and market value of the assets in the trust at time of registration, and country where the trust is administered. The TRS only collects information on the values at the initial registration.

Additional information about either actual or potential beneficiaries is required – NIC number (for individuals), UTR (for organisations), address. It is possible to use a description of the class of persons to identify (actual or potential) beneficiaries. Where a beneficiary is un-named, being only part of a class of beneficiaries, a trustee will only need to disclose the identity of the beneficiary when they receive a financial or non-financial benefit from the trust.

Trustees (or agents) will also have to give other details about the trust if they are registering it for SA purposes, such as the tax years that it has to pay tax.

Deadlines

What is the deadline for registering non taxable relevant trusts falling within the 5MLD extended registration requirements?

At the time of writing, an exact date is unknown because the Trust Register cannot currently can't accept the registration of non taxable trusts.

HMRC originally had a March 2021 target for fundamentally upgrading the service. That fed through to a March 2022 deadline for trusts to register on the TRS or update their records for additional beneficial ownership information if they were already registered. In other words, HMRC were offering a transition period of up to one year.

“HMRC then announced that it would not meet the March 2021 target date and instead the target date was pushed back until sometime in summer 2021. Subsequently this was further delayed to sometime in Autumn 2021.”

Accordingly, HMRC intends to defer the deadline until twelve months after the date of actual delivery of the expanded register, so as to give trustees and agents of existing trusts enough time. That therefore gives rise to an approximate deadline of Autumn 2022. Remember that’s a backstop and so trustees, or their agents should be able to register anytime from Autumn 2021.

In due course, trustees will have just 30 days to register and updates will be required to existing information held on the register within 30 days from the date they become aware of the changes.

Don’t forget there will be trusts which are required to register because they have UK tax liabilities. Those trustees should comply with the existing timescales. So, for example, if the trust becomes liable to income tax or CGT in 2020/21 for the first time then it must register by 5 October 2021.

C. The Taxation of Trusts

C.1 The Modernisation of Trust Taxation

The stated objective behind the reforms of trust taxation which began with the 2003 pre-Budget report, was to achieve transparency, so that those benefiting from trusts pay tax at the same rate as they pay on their personal income and gains.

The first stage of the reforms was targeted at trustees of discretionary and A&M trusts, who have the power to accumulate income and the discretion to decide who should benefit. To address the potential loss of higher rate tax arising from this situation, the rate of tax applicable to trust income (the Rate Applicable to Trusts – 'RAT') was increased with effect from 6 April 2004 for dividend and all other income. This rate has since varied. In 2021/22, the dividend trust rate is 38.1% and the trust rate for other income is 45%. The 'standard rate' of £1,000 is discussed below.

A high RAT acts as a deterrent to the accumulation of income within discretionary and A&M trusts since, to the extent that income is paid out to beneficiaries, increases are tax-neutral. Additional rate taxpayers have no further liability and basic and higher-rate taxpaying beneficiaries, as well as those who are not subject to tax, are able to reclaim the excess over their personal liability. This contrasts with the situation for IIP trusts, which continue to be subject to income tax at the basic rate, with any liability for higher rate or additional rate tax falling subsequently on the beneficiaries – a less satisfactory situation from the point of view of HMRC's cash flow.

Further changes were made to the income tax treatment of trusts in 2005, when the Finance Act introduced new rules for trusts for the vulnerable (see B.1.5.1) and a £500 standard rate tax band for discretionary and A&M trusts (see C.2.1.1). This was subsequently increased to £1,000 from 6 April 2006.

As far as capital gains tax (CGT) is concerned, all (non bare) trusts are treated similarly. For gains in excess of the trustees' annual exemption, the main rate for trustees is 20%. The rate is however 28% for gains on residential property not eligible for Private Residence Relief. However, transfers of assets into all trusts other than bare trusts are eligible for CGT holdover relief from 22 March 2006.

Previously this had only been available for transfers into discretionary trusts.

The Finance Act 2006 introduced major tax changes to the IHT treatment of trusts, bringing IIP and A&M trusts into line with discretionary trusts by denying transfers into such trusts the status of Potentially Exempt Transfers which they had previously enjoyed. Transfers to all types of trust other than bare trusts or trusts for disabled persons are now Chargeable Lifetime Transfers, on which IHT will be payable at the rate of 20% if the transfer in question takes the donor's cumulative total of chargeable transfers in the preceding seven years over the nil rate band threshold at the date of the transfer. Additional tax may be payable if the settlor dies within seven years. Given the greater flexibility of discretionary trusts over IIP and A&M trusts, lifetime trust planning for IHT purposes has polarised since March 2006 into a choice between bare trusts and discretionary trusts.

The nil rate band remains extremely important, and for example, allows wealthy benefactors to gift sums up to this limit into trust every seven years. Nil rate band will trusts remain commonplace; and at the time of writing, transfers into trusts of assets which attract 100% business property relief – e.g. shares in the settlor's family company and certain AIM shares are also effective, though arguably higher-risk.

A government consultation, **The Taxation of Trusts: A Review** was carried out between November 2018 and February 2019.

Its aim? To seek views and evidence on whether and how to make trusts more transparent and their taxation fairer or simpler. Much activity followed – an HMRC workshop with interested parties, separately HMRC also met with representatives from the insurance industry and a 'Big 4' accountancy firm, and just over 100 formal responses were received.

A lot of ground was covered.
For example.

- Does adherence to the principles of transparency, fairness and neutrality, and simplicity deliver an effective trust taxation system?
- Can trust transparency be further enhanced?
- Thoughts on the UK's approach to the tax residence of trusts?

- Should there be targeted reform to the IHT regime as it applies to trusts?
- Should there be simplification of the vulnerable beneficiary trust regime?

The outcome?

The government advised on 23 March 2021 that “the responses did not indicate a desire for comprehensive reform of trusts at this stage.”

There is therefore to be no wholesale changes to trust taxation.

The issues raised will however be kept under review by the Government to ensure that the long term approach to trust taxation remains on track. In the shorter term of course, we may encounter specific areas of trust taxation dealt with on a case-by-case basis.

Future uncertainty can lead to delays in current planning and with that in mind, this is good news for mainstream financial planning. Trusts play an important part in IHT and estate planning strategies and it is important that clients have confidence in the stability of the potential tax implications to implement those planning ideas.

In short, steady as she goes for trust planning.

Note also the work done by the Office of Tax Simplification (OTS) on IHT. On 23 November 2018, the OTS published its First Report regarding its review of the IHT regime requested by Philip Hammond when he was Chancellor. This concluded that too many people have to fill in IHT forms, with the process being complex and old fashioned. The recommendations therefore relate to administrative issues. The second report covering wider areas of concern (technical and design issues) was published in July 2019. On 23 March 2021, the government announced that it will reduce administrative burdens for those dealing with IHT. Reporting regulations will be simplified so that from 1 January 2022 over 90% of nontaxpaying estates each year will no longer have to complete IHT forms for deaths when probate or confirmation is required. In addition, the existing temporary provision for those dealing with a trust or estate to provide an IHT return without requiring physical signatures from all those involved will be made permanent.

Also, in July 2020, Rishi Sunak wrote to the OTS requesting a review of CGT and aspects of the taxation of chargeable gains in relation to individuals and smaller businesses. The OTS published a scoping document and a call for evidence in two sections – high-level comments on the principles of CGT, and more detailed comments on the technical detail and practical operation of CGT. The first report – simplifying by design" was published on 11 November. The second report is due in 2021.

This first report covered four interlinked areas where there are policy choices for government to make

- Rates and boundaries
- The Annual Exempt Amount
- Interaction with lifetime gifts and IHT
- Business Reliefs

The underlying theme of their recommendations is the focus on tackling aspects which distort behaviour or introduce complexity.

The remainder of this section of the handbook considers the way in which income tax, CGT and IHT affect each of the main types of trust. The differences are so marked that some trustees might wish to consider, for example, converting a discretionary trust to an IIP or bare trust.

C.2 Income Tax

C.2.1 Discretionary and A&M Trusts

C.2.1.1 The £1,000 p.a. 'standard rate' band

The Finance Act 2006 provided that trustees of discretionary trusts and A&M trusts will pay tax on the first £1,000 p.a. slice of trust income at only the standard rate (which from 6 April 2008 equates to the basic rate of 20%). Dividend income is taxed at 7.5%. Where the trustees´ annual income exceeds £1,000, the excess is chargeable at the RAT (45% for non-dividend income and 38.1% for dividend income from 6 April 2016). Previously the threshold for the standard rate had been £500.

HMRC anticipated, on the introduction of the original £500 standard rate band, that around one third of all trusts previously liable to tax at the RAT would no longer pay the RAT on any of their income because their total income would fall below the threshold; also that where trusts have income which is consistently below the threshold, a trustees' self-assessment tax return would be issued only once every five years in normal circumstances.

Income within the first £1,000 is taxed according to its nature. Dividend income is taxed at 7.5%. Savings income is taxed at 20%. Remember that interest from banks, building societies and OEICs is paid gross. Rental income is taxed at 20%.

In its August 2019 "Trusts and Estates newsletter", HMRC stated

"*In 2016 the requirement to deduct tax at source on bank, building societies and National Savings and Investments (NS&I) income was removed and income from these sources is now paid gross. As a result, trustees and personal representatives had increased reporting requirements.*

We introduced an interim arrangement so trustees or personal representatives do not have to submit returns, or make payments under informal arrangements, where the only source of income is savings interest and the tax liability is below £100. These arrangements have been extended to include the 2019/20 to 2020/21 tax years, and we will continue to review the situation longer term."

HMRC's August 2005 Tax Bulletin stated that if there are mixed sources of income within the trust, income liable to tax at the basic rate will form the first slice of the £1,000 band, followed by chargeable event gains under insurance policies and then by dividend income – i.e. a different order from that applicable to individuals.

If the same settlor sets up several trusts, the £1,000 standard rate band will be apportioned between them: so if two trusts were established, each would have a £500 standard rate band. The minimum standard rate band is £200, no matter how many trusts may have been established by the same settlor.

Example 1

If a trust has total gross income of, say, £1,200 comprising rent of £400, building society interest of £400 and dividend income of £400, tax would be due on the rent and interest amounting to £800 at 20%. This would mean that £200 of dividends would be taxed at 7.5% and the balance of £200 at 38.1%. Note that the trustees do not receive the dividend 'allowance'. In any event, and for information, technically, it is a dividend 'nil rate' rather than an allowance.

Example 2

If, in the situation above, there are in addition, say, £45 of trust management expenses, these would be set off in full against the dividend income.

Example 3

If the situation is the same as in Example 1 but, in addition, there is a £200 gain under a UK investment bond, and the trustees are liable, then, tax would be due on the rent at 20% and on the interest at 20% and the balance of the available £1,000 band would be used up by the gain under the life policy. Tax at 20% will be deemed already to have been paid within the fund and thus there will be no more tax to pay on the gain. This means that the whole of the dividend income will be above the £1,000 band and will therefore be fully taxed at 38.1%.

The following sections apply to the taxation of income which exceeds the £1,000 standard rate band.

C.2.1.2 The treatment of Savings Income and Dividend Income

Savings Income received by Trustees

In 2021/22, trustees are subject to income tax on trust income other than dividend income at the RAT of 45%. When this income takes the form of savings income, remember that this is paid gross. If trustees receive any income net of 20% tax, then the trustees will be liable for an additional 25% tax.

Bank interest received by the trustees	£800
RAT @ 45%	(£360)
Amount available to distribute to beneficiaries	£440

Trust Income received by Beneficiaries

Beneficiaries will be subject to tax on income distributed to them, or for their benefit, by trustees and will be able to recover from HMRC any difference between the tax paid by the trustees (45%) and their own rate of tax. The beneficiary will be in receipt of trust income and not savings income meaning that the Personal Savings 'Allowance' will not be available against that income.

Non-taxpayer reclaims	£360	Retains in total	£800
Basic rate taxpayer reclaims	£200	Retains in total	£640
40% taxpayer reclaims	£40	Retains in total	£480
45% taxpayer reclaims	£0	Retains in total	£440

Note that Scottish and Welsh income tax, applies to non-savings, non-dividend income only. Income payments from discretionary trusts (i.e. trust income) will therefore be liable at the Scottish/Welsh rates when paid to Scottish and Welsh beneficiaries. For the avoidance of doubt, the trustees will be subject to tax at UK rates, and provide the Scottish/Welsh beneficiary with a tax credit for the amount of tax paid at the UK rate.

Dividend Income received by Trustees

From 6 April 2016, the government abolished the dividend tax credit and introduced a new dividend nil rate. In 2021/22, the nil rate is £2,000, but is not available to trustees. Also from 6 April 2016 the dividend trust rate increased to 38.1% (from 37.5%).

Dividend received by trustees	£800
RAT @ 38.1%	£304.80
Amount available to distribute to beneficiaries?	£495.20

Dividend Income received by Beneficiaries

We now need to consider the position if the trustees exercise their right to distribute dividend income to beneficiaries rather than accumulate it within the trust. Dividend income which is distributed ceases to be regarded as dividend income and is regarded instead as trust income. Consequently, the beneficiaries cannot use their dividend nil rate to offset against that trust income. The trustees must account for tax at 45% on this income distributed.

Let’s assume firstly that the trustees wish to distribute £495.20 to a beneficiary. That needs to get paid with a 45% tax credit. So, £495.20 x 45/55 = £405.16. But, the tax paid by the trustees is only £304.80. If there is sufficient tax in the tax pool, then the trustees can use £100.36 of that. The beneficiary therefore receives £495.20 with a tax credit of £405.16. In gross terms that is £900.36. The tax pool comprises the amount of tax paid by trustees in prior years on income received but not distributed to beneficiaries.

If the trustees have no tax pool available then the trustees can pay £55.20 more tax i.e. £304.80 + £55.20 = £360. The trustees are therefore topping up the tax paid by 6.9% (6.9% of £800 = £55.20). This gives rise to total tax of 45% (38.1% + 6.9%). The distribution then falls by £55.20 i.e. £495.20 – £55.20 = £440. In gross terms that is £800.

Net payment from the trust	£440		
Non-taxpayer reclaims	£360	Retains in total	£800
Basic rate taxpayer reclaims	£200	Retains in total	£640
40% taxpayer reclaims	£40	Retains in total	£480
45% taxpayer reclaims	£0	Retains in total	£440

The third option is that the trustees may decide to simply restrict the distribution to tie in with the £304.80 tax paid. That would ‘cover’ a distribution of £372.53. In gross terms, that is £677.33.

Expenses

None of the examples quoted above allows for expenses to be deducted, the inference being that there is other income (or indeed capital) accruing to the trust from which such expenses can be deducted (as to expenses generally, see B.4.2 above).

C.2.2 Interest in Possession ('IIP') Trusts

C.2.2.1 The trustees

The trustees are liable to basic rate tax on income arising in the trust fund. Where gross interest is received, the trustees will have a basic rate liability of 20%.

With regard to dividends, the trustees will have a liability of 7.5%.

C.2.2.2 The beneficiaries

Beneficiaries who are entitled to the income are personally liable to tax on it whether it is drawn or left in the trust fund. Beneficiaries receiving distributions from an IIP trust are entitled to a tax credit for the rate tax paid (or effectively paid) by the trustees in respect of rental, savings income or dividend income. The beneficiary should receive a statement of trust income from the trustees. Form R185 is typically used. Where the beneficiary has received income from the trustees net of tax, the net income is grossed up in the beneficiary's tax return since the beneficiary is entitled to, and taxable on, the gross amount. The beneficiary should use the SA107 to declare income from a trust. Note that this also is used for discretionary income payments from a trust (see above). The same form is also relevant for payments from settlor-interested trusts.

The situation is different where the income of the IIP beneficiary is treated as that of the settlor under the settlements legislation i.e. where the IIP beneficiary is a spouse, civil partner or minor child of the settlor.

Income from an IIP trust will retain its nature meaning that the tax due by the beneficiary will reflect the dividend nil rate, the starting rate for savings income and the personal savings nil rate as appropriate. Certain expenses will be deductible when calculating profits (e.g. allowable letting expenses in a property business). Allowable Trustees' Management Expenses reduce the beneficiary's entitlement to income rather than reducing the trustees' tax liability.

It is possible for trustees to mandate trust income to a beneficiary. If the trustees mandate income to a beneficiary, it means that the beneficiary receives it and the trustees do not. In such a case there is no statutory basis for taxing the trustees as receiving income. The beneficiary both receives the income and is entitled to it.

The trustees therefore exclude the income from the trust and estate tax return and the beneficiary (or, where the settlor has retained an interest, the settlor) includes the income on his/her tax return.

C.2.3 Bare Trusts

The tax treatment of these trusts reflects the substantive position – the trust is effectively ignored with any income tax (or CGT or IHT) liability falling on the beneficiaries at their own rates subject to their own personal allowances and exemptions. The exception to this principle is that income arising from assets placed in trust by parents for their minor children (who are neither married nor in a civil partnership) after 9 March 1999 is taxed as the donor's income if it exceeds £100 pa, regardless of whether it is paid or applied for the benefit of the child. The relevant legislation is comprised in ITTOIA, S629 (the parental settlement rules). Income produced by assets placed in trust by grandparents for their grandchildren will be taxed as the child's even if it exceeds £100pa. “Minor” means a person under the age of 18 years.

On the disposal of assets, capital gains will have the benefit of the child's full annual exemption (not just the one-half exemption available to trustees).

Since 6 April 2007, gains that arise due to a chargeable event on a life assurance policy which is held under a bare trust for a minor beneficiary are deemed to be the gains of the minor beneficiary. Previously HMRC took the view that the tax charge fell on the settlor. However, if the settlor of the trust is the parent of the child, and the gains exceed £100, the gains will continue to be assessed on the parental settlor. In the case of a bare discounted gift trust, the tax position can be complex.

C.2.4 Trusts where settlor retains an interest

Income arising under a settlement is taxed on the settlor if it arises from property in which he/she has an interest. This will be the case if there are any circumstances where property is payable or applicable for the settlor or the settlor's spouse or civil partner, or will or may become so payable or applicable. This applies even if the income is not actually paid out.

Where any income tax becomes chargeable on and is paid by the settlor, he or she is entitled to recover tax paid from the trustees. An important exception relates to outright gifts between spouses or civil partners. The rules do not apply to these outright gifts if two conditions are satisfied. First, the gift carries a right to the whole of the income. Secondly, the gift is not wholly or substantially a right to income.

C.3 Capital Gains Tax

C.3.1 IIP, Discretionary and A&M Trusts

As a result of IIP and A&M trusts being brought into line with discretionary trusts for the purposes of IHT, any capital gains on the transfer of chargeable assets into these trusts from 22 March 2006 have become eligible for holdover relief from CGT purposes under s260(2)(a) of the Taxes and Chargeable Gains Act 1992. The crystallisation of gains can thus be deferred until the asset transferred is realised by the trustees (or following a further holdover claim realised by a beneficiary).

From 6 April 2016, the main CGT rate for trustees and personal representatives was reduced from 28% to 20%. The 28% rate was however maintained for gains on residential property not eligible for private residence relief. The annual exempt amount is generally half the exemption available to individuals. Where a number of trusts have been created since 6 June 1978 by the same settlor, the trustees exemption is divided equally between them, subject to a minimum exemption of one fifth of the available amount.

Where an individual becomes absolutely entitled to trust property during his or her lifetime, the trustees will be treated as making a chargeable disposal for CGT. However, an election can be made to defer the CGT liability by claiming hold-over relief, regardless of the nature of the assets being distributed, provided that the beneficiary is becoming absolutely entitled to the trust assets without previously having been entitled to an interest in possession. (Look out for situations in which a beneficiary of an A&M trust attains an interest in income on attaining age 18 or 25, then becomes entitled to capital at a later date.

Tax is then payable by the beneficiary when he or she finally disposes of the asset, and the acquisition cost is reduced by the amount of the held-over gain.)

Prior to 22 March 2006 the value of trust assets were re-based for CGT on the death of the beneficiary of an IIP trust. Consequently there was no liability to CGT but the trustees were regarded as making a disposal of the trust assets at the then market value and the assets were deemed to have been acquired at their new base cost. This is still the position for IIP trusts created before 22 March 2006 which have not subsequently been altered to bring them within the new provisions for 'relevant property' in trusts (see C.4.1.1 below). This re-basing facility ceased for IIP trusts created on or after 22 March 2006 and consequently, as from that date, the death of a beneficiary will not give rise to any CGT re-basing. As previously mentioned, it is now possible to hold over gains on the creation of an IIP trust on or after 22 March 2006.

C.3.2 Bare Trusts

The tax treatment of these trusts reflects the substantive position – the trust is effectively ignored with any CGT liability falling on the beneficiaries, subject to their own annual exemption. In 2021/22, tax is therefore be payable at 10% where total taxable gains and income are less than the higher rate threshold. The rate is 20% in respect of gains (or any part of gains) above that limit. For gains on residential property not eligible for private residence relief, and carried interest, then the rates are 18% and 28%.

C.3.3 Trusts where the settlor and/ or spouse/ partner is a beneficiary

With the introduction of a flat rate of CGT for all trustees and individuals from 6 April 2008, the settlor interested CGT provisions were abolished.

Where parents create bare trusts for the benefit of their minor children, gains can continue to be set against the children's annual CGT exemption.

C.3.4 CGT on the winding up of a trust

In the event of the winding up of a trust and the distribution of assets to the beneficiaries, the trustees might either realise the value of the assets or distribute these in specie to the beneficiaries.

In the event of realisation, the trustees would have the benefit of the annual CGT exemption equal to half that applicable to individuals; and in the event of the assets being distributed in specie, the CGT liability could be reduced by the trustees first realising a value equivalent to their exemption and then, provided that the trust falls within the "relevant property" regime (see C.4.1.1 below), the trustees and beneficiary could elect to hold over the remainder of the gain so that the beneficiary can subsequently use their own annual CGT exemption when realising the remainder of the value of the assets – a process which could take place over a number of tax years.

C.4 Inheritance Tax

As a result of the Finance Act 2006, transfers made on or after 22 March 2006 into all types of trust other than bare trusts and trusts for disabled persons are chargeable transfers.

C.4.1 Discretionary Trusts

C.4.1.1 The tax position on commencement

A discretionary trust (also referred to as a 'relevant property' trust) is one in which no qualifying interest in possession exists.

A lifetime transfer into this type of trust has always been a chargeable transfer for IHT purposes.

If the chargeable lifetime transfer (CLT) exceeds the value of the nil rate band after taking into account any other chargeable transfers made by the settlor in the previous seven years (potentially exempt transfers (PETs) are not included in this cumulation), then tax is charged at the rate of 20% – i.e. half the rate applicable on death – assuming that the trustees pay the tax. If the immediate charge is paid by the settlor rather than from the trust fund, the amount payable will be grossed up by 25% as the tax payment represents a further gift by the settlor.

If the settlor dies within the following seven years there may be a further tax charge of 20% (assuming the death rate remains at 40%) subject to any available taper relief. The gift is measured against the settlor's NRB available at death and if this is exceeded a calculation is done based on the full death rate of 40%. Any failed PETs are included in the calculation. Gifts eat into the settlor's NRB in chronological order.

Form IHT 100 is used to inform HMRC about a number of occasions on which IHT may arise including lifetime gifts into a discretionary trust. A separate form is then required to inform HMRC about each individual chargeable event. In the case of an individual setting up a discretionary trust, that separate form is IHT100a. This requirement is made clear in Section A of IHT100 which contains various tick box 'chargeable events". Part A1 deals with "Gifts and other transfers of value including failed potentially exempt transfers". If that box is ticked, then it is necessary to complete 'event form' 100a.

The limits for not having to report a CLT made by an individual are as follows:

- Where the value transferred is attributable to either cash, quoted shares or securities, and that value, together with the transferor's CLTs in the previous seven years, does not exceed the threshold for IHT for the year in which the transfer was made. If there are any other non-cash type assets involved in the transfer, then the transfer cannot be included under this test.

  However, where the transfer is cumulated with earlier gifts, they do not all have to be attributable to cash or quoted shares or securities: only the current gift has to satisfy the test.
- For other transfers where:
  - the value of the CLT, together with the transferor's CLTs in the previous seven years, does not exceed 80% of the current IHT threshold, and
  - the value of the CLT does not exceed the IHT threshold less the value of the transferor's CLTs in the previous seven years.

The purpose of this second part of the test is to make it a requirement to deliver an account where the value transferred exceeds the IHT threshold that is available to the transferor – but the CLT that emerges remains below the threshold due to exemptions (e.g. the £3,000 annual exemption) or reliefs (e.g. BPR or APR).

A transfer on death will also constitute a chargeable transfer, but no annual exemptions may be deducted, and IHT will be payable at 40%, assuming that the value of the transfer is more than the nil rate band current at the time.

C.4.1.2 The 10-year periodic charge

On each tenth anniversary of the creation of the trust there may be an IHT charge. This calculation happens on each subsequent 10th anniversary until all of the trust assets have been distributed to chosen beneficiaries, and applies regardless of whether the settlor is alive or dead. Reporting is carried out by the trustees using Form IHT 100d. If tax is due, then payment is prima facie the responsibility of the trustees. This charge is often referred to as the periodic or principal charge. Any tax is due six months after the month of the event.

The principle of the IHT charges applying to relevant property trusts is that tax paid should be comparable to a charge of 40% once a generation. This is achieved by a potential 20% lifetime charge on the settlor and three ten-year periodic charges at 6% (3/10ths of 20%) on the trustees.

Therefore, the rate at which tax is charged is 30% of the 20% lifetime rate i.e. 6%. The periodic charge is based on a hypothetical lifetime transfer, as if the trust funds were transferred at the 10 year anniversary. The rate cannot exceed 6%.

The detail below reveals that the value of any CLTs made by the settlor in the 7 years before establishing the trust will impact on 10 yearly charges. Beware however the situation where after the trust commences, but before the 10 year anniversary, the settlor makes an addition to the trust. That triggers S67(1) IHTA 1984 (anti-avoidance section). In such cases, the settlor's cumulative total in Step 2 below will be the higher of:

- Total CLTs made in the 7 years prior to commencement, or
- Total CLTs made in the 7 years prior to the date of the addition (but disregarding transfers made on the same day).

This is just an overview as it is a complex area.

The periodic charge is calculated as follows.

Step 1. Calculate the notional lifetime transfer.

This comprises

- Value of the trust fund at the 10 year point (net of BPR and APR). Add
- 'Historic' value of any related settlements (see below)

Step 2. Calculate the 'special' cumulation

This comprises

- Value of any CLTs made by the settlor in the 7 years before establishing the trust
- Value of property distributed from the trust fund during the previous 10 years

Step 3. Calculate the Aggregate Chargeable Transfer

This comprises

- Step 1 plus Step 2

Step 4. Deduct the NRB at the 10 year point

If the NRB is greater than the Aggregate Chargeable Transfer then there is no tax due at the 10 year point.

Step 5. Multiply the Step 4 figure by 20%

Step 6. If the special cumulation figure in Step 2 exceeds the NRB then Steps 4 & 5 are calculated using the Step 2 figure. This notional tax calculated is then deducted from the tax on the Aggregate Chargeable Transfer. That equals the tax on the hypothetical transfer.

Step 7. The effective rate can then be calculated – (Step 5 or 6 divided by Step 1) x 100

Step 8. The actual rate of tax is 30% x Step 7.

Step 9. This is the tax paid by the trustees which is the actual rate x the value of the trust fund at the 10 year point.

Therefore, if the settlor had made no CLTs in the 7 years prior to setting up the trust, and if there was no capital distributed in the first 10 years, then the trustees will have a full NRB for the purposes of the periodic charge.

If however the settlor had made previous CLTs of (say) £300,000 and £30,000 capital had been distributed from the trust in the first 10 years, then if the NRB at the 10 year point is £325,000, then trustees will have a NRB of £0 (it cannot be negative).

Example 1

- CLTs made by client in 7 years before establishing the trust = £0
- Value of property distributed in previous 10 years = £0
- Value at 10 year point = £650,000
- Value derived from related settlements = £0
- Nil Rate Band at 10 year point = £387,000

Tax calculation

- Special cumulation £0 + Hypothetical transfer £650,000 = £650,000
- 20% x £650,000 less £387,000 = £52,600
- Effective rate = £52,600 / £650,000 = 8.0923%
- Tax payable at 10 year point = 8.0923% x 30% x £650,000 = £15,780

Two settlements are related if, and only if, the settlor is the same in each case and they commenced on the same day. With that in mind, where property is added to a number of related settlements on the same day, the value of the addition to all the settlements concerned and the initial value of relevant property settled in each settlement is taken into account (there are exclusions for charitable funds, lifetime transfers less than £5,000 and additions which are payments of regular life insurance premiums).

Income which has remained undistributed income for more than five years at the date of the ten year anniversary is treated as if it were part of the capital for the purposes of the periodic charge (this does not change the identity of the income when it is distributed to beneficiaries for income tax purposes.

Where any part of the property has not been in trust for the full ten years (e.g. added funds), the rate of tax charged on that part of the property will be reduced by 2.5% (1/40th) for each of the successive quarters (i.e. periods of 3 months) which expired before the property became comprised in the settlement.

"Excluded property" is also ignored in calculating a periodic charge.

C.4.1.3 The exit charge

An exit charge when capital leaves the trust is also known as a proportionate charge. Two scenarios are possible. Firstly, distributions out of the trust within the first ten years, and secondly distributions out of the trust after the first ten year anniversary has passed. Any tax is due six months after the month of the event.

The exit charge is based on the time that has elapsed since the commencement of the trust or from the date of the last ten-year anniversary if later. Again, the maximum rate is 6%. The chargeable transfer must be reported to HMRC on the exit form IHT 100c; and any tax liability is the responsibility of the trustees.

The rate of tax chargeable on exits before the first ten-year anniversary is 30% of the 'effective' rate multiplied by 2.5% (1/40th) for each successive quarter since commencement of the trust. So, for example, if capital 'exits' the trust two years before the ten year anniversary then the quarters factor would be 32/40 since there are 40 quarters in a ten year period. Any quarter expiring before the day on which property was added to the trust will be ignored. The 'effective' rate is the average rate that would be charged if an individual had made a CLT equal to:

- the value of property comprised in the trust or related trusts (see above) immediately after it commenced, and
- the value of any property subsequently added to the trust immediately after its addition.

In determining the rate of tax applicable to this hypothetical transfer, any chargeable transfers made by the individual during the seven years immediately before the trust commenced, will be reflected.

A simple explanation of the effective rate is as follows.

Individual who has made no previous gifts, transfers £400,000 into a discretionary trust when the NRB is just £325,000. That £75,000 excess gives rise to lifetime tax at 20% of £15,000. The effective rate therefore is £15,000/£400,000 = 3.75%

Assume that the trustees then distribute £20,000 of capital to a beneficiary, two years before the 10 year anniversary. The exit charge would be calculated as follows.

How many quarters? There are 40 in a 10 year period, so 8x4 = 32 = 32/40

Settlement rate? 30% x effective rate = 30% x 3.75% = 1.125%

Tax charge? It will be £20,000 x 1.125% x 32/40 = £180.

In many cases, particularly where the settlor had made no chargeable transfers in the seven years preceding the settlement, there would be little, if any, exit charge before the first 10-year anniversary.

The rate of tax chargeable between ten-year anniversaries will be the appropriate fraction of the rate at which it was charged at the last ten-year anniversary. However, there are situations where the rate at the last anniversary must be adjusted to take account of changes between the last anniversary and the date of charge. For example, an adjustment is made if the NRB has changed but only if it leads to a reduction. If so, then you recalculate the NRB available using the new lower band.

When calculating potential exit charges, the trustees can again avail themselves of BPR and APR where appropriate.

"Excluded property" is also ignored in calculating an exit charge.

On the death of a beneficiary, no IHT charge arises because no part of the trust fund is deemed to form part of the deceased beneficiary's taxable estate.

C.4.1.4 Simplifying the charges on trusts

In July 2012, HMRC published a consultation document titled "Inheritance Tax: Simplifying charges on trusts." This was the start of a long running consultation exercise. The changes that resulted from this exercise include the following:

(a) Trustees of relevant property trusts must deliver the IHT account six months after the end of the month in which the chargeable event occurs and pay the tax by the end of the same period. This is designed to ensure that returns and payments continue to be submitted evenly throughout the year.

(b) Income that has remained undistributed for more than five years at the date of the ten year anniversary is treated as if it were part of the trust capital for the purposes of the ten year anniversary charge. To avoid the need for trustees to keep very detailed records, tax is then charged on the ten year anniversary at the full rate on any such undistributed income without any proportionate reduction to reflect the period during which the income had been retained.

A high profile aspect of the consultation was a proposal to introduce a settlement nil rate band. This was in response to the fact that provided a settlor created trusts on different days then each trust would had its own nil rate band. It was announced however in the 2014 autumn statement that HMRC would not proceed with this proposal but instead introduce new rules to target avoidance through the use of multiple trusts, and simplify the calculation of trust rules. This announcement led to the following

(c) "Same day additions" into two or more settlements will be taken into account when calculating the periodic and exit charges on each settlement".

In addition to this, various other amendments were introduced.

C.4.2 A&M Trusts

C.4.2.1 A&M Trusts created on or after 22 March 2006

These are now not common.

Following the Finance Act 2006, all transfers into A&M trusts on or after 22 March 2006 are treated as chargeable transfers and therefore taxed in the same way as discretionary trusts as described above. There may be an immediate charge to IHT to the extent that the value transferred, after deducting any available exemptions and taking account of any existing chargeable transfers made by the same settlor within the previous seven years, exceeds the current nil rate band.

Ten yearly charges and exit charges may also be payable.

However, an exception to this general rule is a trust created in a will in favour of a minor child (not grandchild) of a deceased parent which can vest the benefit absolutely in the child between the ages of 18 and 25 (a so called '18 to 25 trust'. If the benefit vests absolutely at age 18, then no charge to tax will arise at that time.

If the trust continues after age 18, then at age 18 the trust will become subject to the 'relevant property' trust regime but there will be no entry charge.

This means that, if the child becomes absolutely entitled at the last possible time for 18 to 25 trusts – i.e. at the age of age 25 – then the discretionary trust regime will apply, but the trust will be treated as having started when the beneficiary attained age 18 for the purpose of determining the appropriate fraction of the effective rate to charge.

The maximum exit charge that can therefore arise when the beneficiary becomes absolutely entitled at age 25 is 4.2%, which is 28 quarters into the first ten yearly charge period. If the beneficiary became absolutely entitled, say at age 21, then the maximum exit charge would be 1.8%, that is, three tenths of 6%.

If the value of the gift to the trust on death plus the cumulative total of chargeable transfers made by the deceased in the seven years prior to death is less than the nil rate band applicable when the beneficiary become absolutely entitled, there will be no tax charge.

That may appeal to parents looking for additional control over young beneficiaries becoming entitled to large sums of money.

C.4.2.2 A&M Trusts created prior to 22 March 2006

Transfers to A&M trusts before 22 March 2006 were classed as PETs and consequently fell outside the regime for 'relevant property' trusts.

The original proposals in the Finance Bill 2006 stated that if such trusts were not amended before 6 April 2008 to give the beneficiary an absolute right to the trust capital on attaining age 18, then it would automatically become a 'relevant property' trust from that date with the ten yearly charges starting on the first ten yearly anniversary of the creation of the trust after 6 April 2008 (albeit on a proportionate basis in view of the fact that the trust property had not been 'relevant property' for the whole of the ten year period).

However, these proposals were amended by the Finance Act 2006 so that the tax treatment outlined above in connection with '18 to 25 trusts' is also generally available for pre-22 March 2006 parental A&M trusts where the settlor has died and the beneficiary is currently under 18, provided that the trust is amended to meet the '18 to 25 trust' rules as above.

C.4.3 IIP Trusts

C.4.3.1 IIP Trusts created on or after 22 March 2006

As a result of the Finance Act 2006, transfers into IIP trusts on or after 22 March 2006 are treated as chargeable transfers and are thus taxed in the same way as 'relevant property' trusts as described above. There may be an immediate charge to IHT if the value transferred, after deducting any available exemptions and taking account of any existing chargeable transfers made by the same settlor within the previous seven years, exceeds the current nil rate band. Ten yearly charges and exit charges may also be payable.

An exception to this is where an IIP trust is created by the will of a deceased person. Typically, this might arise where a person dies and leaves a life interest to a surviving spouse or registered civil partner. For the avoidance of doubt, this does not have to be in favour of a surviving spouse or civil partner. (This life interest is known as an "immediate post-death interest" (IPDI). A life interest in favour of a spouse/civil partner will however be free of IHT.

Even if the trustees have a power of appointment, and can terminate the original life tenant's interest if they so desire, they will be outside the scope of the relevant property regime. The capital supporting the life interest will, of course, continue to form part of the estate of the life tenant in these circumstances.

Remember also that a transfer into a discretionary type trust which exists primarily for the benefit of a disabled person is treated for IHT purposes as if the disabled person had an IIP in the property. This means that transfers into trust will be treated as PETs, although not self-settlements which are not chargeable occasions for IHT purposes because the property remains in their estate.

C.4.3.2 IIP Trusts created prior to 22 March 2006

Transfers to IIP trusts before 22 March 2006 were classed as PETs and consequently fell outside the regime for 'relevant property' trusts.

Such trusts will remain outside this regime provided that no further property is added to the trust on or after 22 March 2006 and that there is no change in the IIP beneficiary after 5 October 2008.

Until 5 October 2008, if the IIP ended while the IIP beneficiary was still alive, to be replaced by a new beneficiary, then that new beneficiary will be taxed under the old rules, with the new beneficiary then having a Transitional Serial Interest (TSI). In other words, there was a window between 22 March 2006 and 5 October 2008 when a beneficiary of an IIP trust could pass on that interest to others such as children. "There is also a spouse or civil partner TSI which arises with a pre 22 March 2006 IIP. Assume that IIP beneficiary is 'A' and his or her IIP ends after 5 October 2008 due to death. If 'B' is the spouse or civil partner and becomes entitled to the IIP, then 'B' will have a TSI so that the trust fund is within 'B's estate. The third type of TSI relates to life insurance trusts. This occurs where there is a pre 22 March 2006 IIP trust and the trust fund comprises an insurance policy. The person with the IIP has an 'earlier interest' and if that person dies after 5 October 2008 but before the life insured then a new beneficiary can acquire a 'present interest' and be treated under the pre 2 March 2006 rules.

With regard to adding property, if someone holds an IIP and property is later added on or after 22 March 2006, then that new property will typically fall under the relevant property regime. For example, assume the trust property comprises shares. In that event, it can be straightforward if the trustees have maintained separate funds for pre and post 22 March 2006 additions with clear values for each, but if the shares have been mixed, then an apportionment will be required.

Note that with a pre 22 March 2006 trust, if there is a change in the IIP beneficiary after 5 October 2008, then IHT is charged as if the beneficiary had made a transfer of value. This will be a PET if the property passes to another individual absolutely.
If however the IIP beneficiary is simply replaced, then the outgoing beneficiary is treated as making a CLT based on the trust fund value at that time, and the trust will become subject to the relevant property regime. In the event of such a change, the trust would become potentially liable to the ten year periodic charge and the exit charge.

In the event of the death of the life tenant, IHT may be payable by the trustees on the value of the trust fund. To protect against this risk, trustees might consider effecting a life policy with similar trustees as the trust, for the benefit of the remaindermen.

C.4.4 Bare Trusts

Transfers to bare trusts are PETs and fall out of the estate of the donor after seven years. The assets held subject to the trust fall within the beneficiaries' estates for IHT purposes.

C.4.5 Trusts where the settlor is a beneficiary

Where the settlor is not excluded from benefiting from the gifted property, he or she is treated as having made a gift with reservation (GWR) and the value of the property in which the benefit has been reserved will be deemed to form part of their taxable estate for IHT purposes (s102 and Schedule 20, FA 1986).

So, for example, if a settlor sets up a discretionary trust and is included within the class of beneficiaries, then that gives rise to a GWR. The creation of the trust would also be a CLT.

The transfer could therefore be taxed twice, once on creation of the settlement and again on death irrespective of when that occurs if the GWR continues until death.

This situation is covered by Regulation 5 of The Inheritance Tax (Double Charges Relief) Regulations 1987 Act. This works as follows.

Make two separate calculations of the total tax payable as a result of the death.

Firstly, charge the GWR as part of the "death estate" (ignoring the value transferred by the original CLT, and

Secondly, charge the CLT in the usual way (ignoring the value of that property at the date of death).

Use the charge on the calculation which produces the higher amount of IHT payable. Where the higher amount results from ignoring all or part of the CLT, then HMRC allow a credit for all or part of any lifetime tax which was originally payable.

If a settlor sets up a discretionary trust and the prospective beneficiaries includes a spouse or civil partner (but not the settlor) that is not a GWR. But if the trustees pay funds to that spouse or civil partner, then the settlor must not share in that benefit – in practice, that may be easier said than done.

D. Investments and their Tax Treatment

The Trustee Act requirement that trust investments should be suitable must be regarded as encompassing not only the composition of portfolios, but also their tax-efficiency and associated administrative costs. This commends consideration of the 'tax wrappers' in which investments may be held, and which provide a number of potential benefits, notably:

- access to professional investment management
- special tax treatment
- diversification within a single holding
- administrative convenience and cost savings.

The main types of tax wrapper of potential interest to trustees are collective investments, Exchange Traded Funds, onshore investment bonds and offshore investment bonds. There are also special types of wrapper for charity investment.

This section of the handbook describes these wrappers and section E suggests which wrappers are likely to be appropriate for which types of trust, having regard to the tax treatment of the trust and that of the wrapper.

Tax wrappers such as OEICs and investment bonds offer trustees access to multi asset funds which work by spreading (diversifying) the investment across a number of different types of assets such as equities, fixed interest bonds, cash and property – from both the UK and abroad. By investing in a number of different assets, the fund manager aims to balance the risk that is being taken. So, in simple terms, if one asset is falling in value then another may be increasing. Examples of multi assets funds could be risk managed active and risk managed passive funds where trustees can access a range of risk rated, globally diversified portfolios targeting different levels of risk and potential return. With active management, the investment team will make decisions about how to invest the fund's money. In contrast a passive fund will aim to produce a return close to a given market or index. Also, via a bond wrapper, the trustees may be able to enjoy multi asset investments with a smoothing process to protect them from short term volatility. The trustees will not benefit from the full upside of any stock market rises, but crucially they will not suffer from the full effects of any downsides. For trustees, acting as custodians of beneficiaries funds, this peace of mind might be invaluable.

D.1 Collective Investment Schemes

Trustees can invest in Authorised Investment Funds (AIFs) – a form of investment fund that enables a number of investors to ‘pool’ their assets and invest in a professionally managed portfolio of investments, typically gilts, bonds, equities and perhaps property. AIFs may be constituted under two different legal forms:

- Authorised Unit Trusts (AUTs), and
- Open-Ended Investment Companies (OEICs)

Unit trusts are established under a trust structure and OEICs established under a corporate structure. Most unit trusts have now been converted to OEICs and therefore for the remainder of this document, reference will simply be made to shares in an OEIC rather than units in a unit trust.

With regard to OEICs, ‘open ended’ simply means that the fund can create new shares when there is a net demand, but when sellers exceed purchasers then existing shares are cancelled. The share capital is therefore variable.

In addition, trustees can also invest in investment trusts which are another type of collective investment vehicle. An investment trust will be ‘closed ended’ with a fixed number of shares. Confusingly, they are not constituted as trusts but instead incorporated under company law.

D.1.1 OEICs and Investment Trusts

The shares held by the investor in an OEIC reflect the value of the investments held by the managers, subject to charges. The shares in an investment trust are quoted on the London Stock exchange and usually trade at a discount to the net value of the assets, depending among other things on the gearing of the trust (the extent to which the managers have borrowed to invest) and the attractiveness of the investment proposition. The fluctuation of the discount to net asset value adds an additional layer of risk (and opportunity) to investment trusts, as also does their gearing.

Both of these investment schemes aim to provide income, capital growth or a combination of both to investors.

From an internal tax perspective, OEIC funds are subject to corporation tax at 20% rather than the normal corporation tax rates. Importantly, ‘internal’ OEIC gains are not chargeable gains but instead the investor will be liable to tax on any capital gain when disposing of shares in the OEIC. An investment trust is also subject to corporation tax, but at normal rates. Like OEICs, they are not subject to tax on chargeable gains and again it is the investor who is subject to tax on disposal gains.

OEICs and Investment Trusts will distribute dividends or interest to investors. Interest will be distributed gross. Note that investment trusts can retain up to 15% of ‘income’. In contrast, an OEIC must distribute the total amount available for distribution shown in the accounts.

If an OEIC satisfies the ‘qualifying investments test’ then it will distribute interest. If not then it will pay a dividend. The OEIC satisfies the qualifying investments test if at all times throughout the distribution period the market value of its qualifying investments exceeds 60% of all its investments. Qualifying investments either yield interest or, whilst not being interest, give returns whose economic substance is of a similar nature.

With regard to distributions, an Investment Trust can use a “streaming regime” where it can, if it chooses, designate as an “interest distribution” all or part of any amount it distributes to shareholders as dividends, where it has “qualifying interest income” for the accounting period. Shareholders can therefore be treated as receiving interest or dividend income depending on the circumstances.

Broadly, OEICs and investment trusts pay little or no tax, the principle being that income and gains pass through to the investor. The result is usually much the same as if the investor had invested directly in the underlying securities in the fund.

An investor in an investment trust will typically be able to reinvest dividends and buy new shares through a dividend reinvestment plan (DRIP). The amount reinvested remains income for income tax purposes, and is treated as allowable expenditure for the purposes of a future CGT calculation.

Similarly, investors in an OEIC will typically be offered a choice between income shares which entitle the holder to receive income which is generated; and accumulation shares which make no distributions (though the income which accrues is nevertheless subject to tax on the investor). The investor does not receive any new shares but the value of existing shares is increased. Again, the amount reinvested, which is subject to income tax, will be allowable expenditure for CGT purposes for a later disposal.

It is important that trustees of IIP trusts should select the income option, even if it is their intention to distribute capital in lieu of income. The reason for this is that life tenants are entitled to whatever income might accrue, but in the case of accumulations, the income becomes difficult to trace which is problematic if the beneficiaries demand the income which is their right.

D.1.2 Exchange Traded Funds (‘ETFs’)

Another Collective Investment Scheme is an ETF where the pool of investments is divided up with investors holding a number of shares relative to their contribution.

Investors in ETFs are shareholders, and an ETF therefore is a corporate body whose shares can be traded on a stock exchange, UK or overseas, just like normal stocks and shares.

A wide range of index-tracking options is available through ETFs. They are therefore a type of index-tracking OEIC.

UK-resident ETFs are taxed in the same way as other UK-resident collective investment schemes with respect to the taxation of interest, dividends and capital gains. Most ETF are however established outside the UK and where an offshore ETF is ‘non reporting’, then capital gains will be subject to income tax.

D.2 Onshore And Offshore Investment Bonds

These are non-income producing investments and from a tax perspective, Investment Bonds and Open-Ended Investment Companies (OEICs) are at opposite ends of the investment spectrum. An OEIC generates income for the investor, albeit that with accumulation shares, income is not distributed but instead reinvested and added to capital.

Even so, the distribution remains income for tax purposes. In contrast Bond are non-income producing investments. These contrasting features create many investment and planning opportunities and indeed it may be appropriate for trustees to blend both. If the trustees are looking for returns to be 'smoothed' to dampen down volatility, then a Bond rather than an OEIC investment should be considered.

While an OEIC fits naturally into the rhythm of the UK tax system, which taxes income and gains, that is not the case with non-income producing Investment Bonds which have their own special tax regime. Accordingly, trustees and individuals are subject to the 'chargeable event' tax rules applicable to Bonds. Neither onshore or offshore bonds are 'qualifying' policies for UK tax purposes and therefore chargeable event gains can arise at any time which contrasts with the position for qualifying policies where broadly, only gains in the first ten years are taxable. HMRC succinctly state that the chargeable event regime proceeds by

- Identifying a 'chargeable event'
- Calculating the gain arising
- Attributing the gain to a chargeable person

The chargeable event regime is explored in due course. In the meantime, note that Chargeable event gains on UK bonds are not liable to basic rate tax. The individual (or trustee) who is liable for tax under the chargeable event regime is treated as having paid tax at the basic rate on the amount of the gain. This reflects the fact that the funds underlying a UK policy are subject to UK life fund taxation as discussed below. In contrast, offshore bonds can be issued by life companies based in jurisdictions which impose no tax on the income and gains of the underlying funds – this is known as 'gross roll-up'. Growth may not be entirely tax-free however, due to the impact of irrecoverable withholding tax which may be deducted from interest and dividends received by the fund.

D.2.1 Onshore Bonds

Onshore investment bonds are investment-based single premium life insurance policies.

Although single premium investments, increments (‘top ups) are normally permitted. Monies invested can be directed to a similar universe of funds to that available through onshore collective investments, and most life companies provide links to a wide range of external fund managers.

Whereas OEICs are obliged to distribute all income to investors at least once a year, investment bonds, being insurance policies, produce no income for the investor. Consequently, whatever income arises within the fund is reinvested to increase the overall return; and investments within the fund enjoy favourable tax treatment. So investment bonds provide an effective means for those who pay tax at a higher rate than the basic rate to defer tax liability.

In broad terms, returns accruing within the underlying investment fund are taxed as follows:

- Savings income is taxed at 20%
- Dividend income is exempt
- Rental income is subject to tax at 20%
- Chargeable gains are also taxed at 20%. With regard to indexation allowance, when a capital gain is made on or after 1 January 2018, any indexation allowance is calculated only up to December 2017 (i.e. not the month in which the disposal occurred). When a UK life fund realises a capital gain then some gains are taxable at 20% but other gains are reduced by indexation allowance before being taxed at 20%. For example, a gain on disposal of shares in an ‘interest’ fund would attract no indexation, but a gain on disposal of shares in an equity fund would attract indexation.
- Expenses are deducted from income before tax is calculated (‘I-E’).

The fact that investment bond funds are subject to corporation tax on capital gains represents a disadvantage compared with collective funds, whose internal dealings are exempt from corporation tax on capital gains. However, switches between investment funds held within the bond wrapper are not taxable events for the bond holder.

Investment returns accruing within onshore bond funds are taxed at the rate applicable to insurance companies, with policyholders receiving a 20% tax ‘credit’ on taxable gains which satisfies their liability to basic rate tax on chargeable event gains.

The individual (or trustee) who is liable for tax under the chargeable event regime applying to bonds is treated as having paid tax at the basic rate on the amount of the gain. This reflects the fact that the funds underlying a UK policy are subject to UK life fund taxation.

Many providers offer multiple segments within the bond so that individual segments can be encashed or assigned independently of each other according to the needs of individual beneficiaries.

A unique feature of onshore and offshore investment bonds is the ‘5% rule’. Part surrenders of up to 5% of accumulated premiums can be taken without any immediate tax charge. Where there has been a part surrender, a calculation must be made at the end of the insurance year to see whether a gain has arisen and if so its amount. A gain will then only arise if, the part surrender value(s) received exceed the available 5% allowance. Any allowance not used can be carried forward for use in subsequent years.

An investor can therefore withdraw 5% of a single premium investment each year for 20 years without a chargeable event occurring.

The maximum allowance is 100% of any premium. The allowance will not accrue after 20 insurance years have elapsed but any unused allowance can be carried forward beyond that point (4% for 25 years perhaps).

Investors can therefore enjoy consistent, regular withdrawals. In the case of trusts, the capital sums withdrawn can be advanced by the trustees to the relevant beneficiaries with no personal tax charge.

The chargeable event regime for onshore (and offshore) bonds and its application to trustees and individuals is considered further in E1.3.

Being life policies, investment bonds must meet insurable interest requirements. Insurable interest is the key element in the structure of a life assurance policy, and is fundamental to the policy’s very existence. If there is no insurable interest there is no life assurance policy. The 1774 Life Assurance Act imposes a requirement for the policyholder (e.g. trustees) to show an insurable interest in the life insured at the time the contract is taken out.

For applications, including trustee applications, the relevant insurance company can offer guidance to the applicant(s) as to who can be a life assured. For example, perhaps trustees are both owners and lives assured.

The Law Commission of England & Wales and the Scottish Law Commission have been asked to simplify and update the law relating to insurable interest. Draft legislation has been published but at the time of writing it remains draft.

D.2.2 Offshore Bonds

In addition to onshore investment bonds, trustees may also consider offshore investment bonds.

Offshore bonds, like their onshore counterparts, are single premium life (though see below) policies. Increments are normally permitted. Within the bond 'wrapper', investment income and gains are rolled-up, but because they are based in appropriate jurisdictions such as Dublin, the roll-up is gross (subject to any withholding tax suffered), whereas onshore bonds provide a net roll-up. The benefit of gross roll-up increases with the investment time-frame.

The longer the roll-up period, the greater will be the benefit of the tax-free compounding of investment returns in an offshore bond though bear in mind the impact of taxation on encashment. Clearly there is no 20% 'tax credit' for an offshore bond investor.

Offshore bonds may also be structured as capital redemption policies – i.e. investment wrappers issued by insurance companies which are not life policies (and therefore require no lives assured) but which promise to pay a fixed sum on maturity equal to the higher of the value of the underlying assets and an actuarially calculated multiple of the premium. The fixed term to maturity might be 99 years, but prior to that the bond can be fully surrendered just like a life assurance bond. Also, in the same way as with offshore and onshore investment bonds, investors in capital redemption policies are permitted to withdraw each year up to 5% of the value of the capital invested, with no immediate liability to tax. For the avoidance of doubt, if trustees invest in an offshore capital redemption bond, there will be no lives assured.

The chargeable event regime for offshore (and onshore) bonds and its application to trustees is covered in E1.3

As regards investments held within an offshore bond, it should be noted that if the benefits are closely linked with the value of a portfolio of assets personal to the policyholder, a Personal Portfolio Bond ('PPB') will be deemed to have been created and tax will be levied on a deemed gain of 15% of the total premiums paid to the end of each policy year. Overseas insurers will not therefore offer PPBs to UK investors. These anti-avoidance measures do not apply to portfolio bonds whose investments are restricted to pooled assets which are available to investors generally. For example, a policy is not a PPB if all of the property which may be selected falls within an internal linked fund of the insurer, units in an authorised unit trust, shares in an OEIC and so on.

E. Matching Investments to Trusts

E.1 Discretionary and Accumulation & Maintenance (A&M) Trusts

E.1.1 The problem of accumulating income

The fact that beneficiaries under discretionary (and A&M) trusts have no entitlement to income means that trustees of these trusts are typically able to invest in non-income producing investment bonds, and it is the fact that withdrawals can be made from investment bonds without any immediate tax consequences which commends them for use by trustees of discretionary type trusts. Some managers of collective investments permit capital drawdown from their funds, but such arrangements are typically designed only to augment true income, and each payment has potential consequences for capital gains tax.

In C.2.1. we learned that trustees of discretionary and A&M trusts pay tax on the first £1,000 p.a. slice of trust income at just 20% on interest and 7.5% on dividends. All well and good, but when the annual trust income exceeds £1,000, the excess is chargeable at 45% for non-dividend income and 38.1% for dividend income. If that after tax income is being accumulated by the trustees then that tax suffered is costly from a reinvestment perspective. The benefit of that tax paid by the trustees is only realised when the trustees decide to distribute income to the beneficiaries – but that might be many years down the line. At that time, the trustees need to account for tax at 45% on the income distributed. Only then will the beneficiaries be taxable on the income distributed to them and able to recover from HMRC the difference between the 45% tax paid by the trustees and their own rate of tax. Remember also that the beneficiary will be in receipt of trust income and not savings income meaning that savings and dividend 'allowances' will not be available against that income. Distributing income annually might seem a solution but remember that once it has left the confines of the discretionary trust, then the trustees have lost control of it. This is exacerbated by the fact that beneficiaries are often children and it may not be ideal that they have access to large sums of money (where funds have left the security of the trust) at such a young age.

Investment bonds are therefore popular investments for trusts where the trustees have the power to accumulate income. Dividends received by onshore and offshore life funds are exempt from tax and can therefore be reinvested in full. Onshore, interest will be reinvested net of 20% tax. An investment bond is therefore a suitable vehicle for rolling-up investment returns. In broad terms, consider firstly an investment bond owned by the trustees – a dividend of £800 received into the life fund would be subject to no further tax within the life fund and £800 could therefore be reinvested. Consider now the situation if the trustees owned those equities directly and received a dividend of £800 and they would like to accumulate that income within the trust – it would be subject to tax of £304.80 if held directly by a trustee (assuming income over the standard rate band). That would only leave £495.20 to reinvest.

If the trustees invest in an insurance bond and they want to release funds for a beneficiary then they have various options.

- Encash the bond (or a number of individual segments) and make a capital distribution of the funds after tax (the tax situation is covered in E1.3. The beneficiary then receives capital and not income so no income tax issues for the beneficiary.
- Take part surrenders under the 5% rule and distribute the capital.
- Assign the bond (or individual segments) by way of gift to the beneficiary which is not a chargeable event. Thereafter the beneficiary would be taxable on any subsequent encashment.
- If the beneficiary is a minor and too young to be party to a deed of assignment, then the trustees may wish to consider making an irrevocable appointment under bare trust in favour of that beneficiary.

The fact that investment bonds are non-income producing assets also offers administrative advantages. If the whole of a trust fund is invested in a bond, the trustee accounts will be easy to prepare, and for the years in which there is no chargeable event, the trustees' self-assessment form can be completed with a nil declaration.

If a chargeable event did occur, the form would show whatever was shown on the life company's chargeable event certificate. These benefits may enable solicitors to minimise charges for administering trusts – a factor which is particularly important in the case of smaller trusts.

E.1.2 Tax aspects of capital withdrawals

Can regular payments of capital to beneficiaries be regarded as assuming the nature of income and be taxable as such? (Advancement of capital could also result in an exit charge for inheritance tax purposes but this might be very small and might not arise at all, depending on the circumstances).

In the case of re Brodie's Will Trusts (1933 17 TC 432), the Court held that in a situation where regular payments of income had been made to a beneficiary of an IIP trust and had sometimes been supplemented by payments of capital, the total payment should be regarded as income and taxed as such.

Happily, in the later case of Stevenson v Wishart (1987 STC 266) – which related to a discretionary trust – the Court of Appeal distinguished Brodie in favour of the taxpayer. The case concerned an elderly beneficiary whose nursing home expenses exceeded the income arising from the trust. The trustees made regular payments of capital to meet the balance of the expenses and the Court held that the trustees were exercising a power over capital and that the payments retained their nature as capital and were therefore not to be taxed as income. Fox LJ said:

"There is nothing in the present case which indicates that the payments were of an income nature except their recurrence. I do not think that is sufficient. The trustees were disposing of capital in exercise of a power over capital. They did not create a recurring interest in property. If, in exercise of a power over capital, they chose to make in their discretion regular payments of capital to deal with specific problems of the beneficiary's last years rather than release a single sum to her of a large amount, that does not seem to me to create an income interest. Their power was to appoint capital. What they appointed remained capital".

HMRC's Trusts, Settlements and Estates Manual at 3781 states
A payment made out of trust capital including

- accumulated income
- a capital receipt that is deemed to be income for tax purposes

is normally regarded as capital of the beneficiary and so is not taxable. This view was supported in the case of Stevenson v Wishart and Others (59 TC 740).

Where

- there is no pre-existing interest in income, or
- the payment is made under an interest in capital that is separate from an interest in income
- payments out of trust capital constitute capital in the hands of the recipient.

Examples that illustrate the normal rule are:

- Anthony has no interest in income at all. But the trustees may advance capital to or for him at their discretion. Payments are capital and not taxable on him.
- Barbara has a discretionary interest in income. The trustees may also advance capital to or for her at their discretion. Payments are capital and not taxable on her.
- Carina has an annuity of £10,000 and in addition, the trustees have the power to apply capital at their discretion for her benefit. Payments are capital and not taxable on her."

In 3783, HMRC outline the exceptions to the normal rule. In particular this includes "payments to supplement an income interest." This then links to 3785 where the text is as follows

"The cases of Cunard's Trustees v CIR (27TC722) and Trustees of the will of H K Brodie v CIR (17TC432) established that where there is a pre-existing income interest (whether in the form of an annuity or interest in possession) payments out of trust capital to supplement or augment income constitute income in the hands of the recipient.

Where the beneficiary has a pre-existing annual income entitlement, and the trustees can or have to supplement or augment the trust income out of capital:

- if they can use capital in this way, i.e. it is discretionary, ITA/S494 will apply
- if they have to use capital in this way, the annual payments treatment will apply."

Relating these principles to 5% withdrawals from investment bonds in which trustees have invested, the conclusion may be drawn that no problem should arise from the fact that the trustees' withdrawals might be regular in timing and consistent in amount. The issues raised in Brodie and Stevenson might arise in relation to onward distributions by trustees to beneficiaries, though the dicta in Stevenson provide comfort that issue should not be taken by HMRC. Nevertheless, cautious trustees might consider it prudent to ensure that their payments to beneficiaries are irregular in amount and timing.

Investment bonds are invariably structured in policy segments, which raises the question of whether it might be preferable to exhaust whole segments or to reduce each segment by a sufficient amount to produce the required sum in total. The answer will depend on the tax situation in each individual case.

E.1.3 Liability for chargeable event gains

With a non-income producing investment bond, tax is only payable when a gain is calculated on a chargeable event. The main chargeable events are as follows

- Death giving rise to benefits (if it does not give rise to benefits, then death is not a chargeable event. For example consider a bond with two lives assured which is structured to pay out on second death – on that basis, death of the first life assured does not trigger a chargeable event).
- Assignment of all rights under the policy for money or money's worth (this is rare). If the trustees assign the bond, or segments within it by way of gift to a beneficiary then that does not give rise to a chargeable event.
- Maturity (if appropriate). Again this is rare, most life assurance bonds do not mature and an offshore capital redemption bond will typically only mature after 99 years, and so it is almost inconceivable that it will not be surrendered at an earlier date.

- Where the trustees take a part surrender and the calculation at the end of the policy year indicates that the 5% 'allowance' has been exceeded.
- Surrender of all rights under the policy i.e. a full surrender.

The gain must then be attributed as set out below.

For a (non bare) trust held policy, assuming the individual who created it is not 'absent' (i.e. non UK resident or dead) then that person is chargeable. 'Creator' has a wide meaning and includes any person who settles property on the trust. If at the time the chargeable event occurs the settlor is UK resident and alive, or has died in the same tax year as the event, then any gain will be assessed on the settlor. Where a policy is held on non charitable trust and an individual is liable for tax, then that person may recover the tax from the trustees. The individual may ask HMRC to certify the amount recoverable (S538 ITTOAI 2005). If the settlor does not recover the tax, then that 'omission to exercise a right' would be a transfer of value for IHT purposes (though perhaps exempt within the annual exemption).

The trustees are taxable if the settlor cannot be taxed i.e. the settlor is non UK resident or was UK resident but died in a prior tax year. If the trustees cannot be charged because they are not resident in the UK then the anti-avoidance provisions of S740 ICTA 1988 are applied with certain modifications. The result is that a UK beneficiary receiving a benefit under the trust from the gain will be taxable on that amount with no Top Slicing Relief (TSR) or basic rate credit.

> John takes out an investment bond and assigns it into a discretionary trust. Subsequently the bond is encashed when John is still alive and UK resident.
>
> - John is chargeable on the gain.

Jo takes out an investment bond where she is the sole life assured. She assigns it into a discretionary trust. When Jo dies the chargeable event gain occurring on her death is charged on her.

Where the gain arises after the end of the tax year in which the creator died, the trustees will be taxable on the gain (subject to the transitional 'dead settlor' provisions below).

Jack took out an investment bond in 2010. The lives assured are him and his son. He assigned it into a discretionary trust. Jack dies on 1st May 2021 and the bond continues due to the existence of the second life assured.

If the trustees encash the bond prior to 6 April 2022, the gain will be chargeable on Jack (the deceased).

If the trustees encash post 5 April 2022, the gain will be chargeable on the trustees.

In 2010, Ken and Karen jointly set up an investment bond under a discretionary trust. Ken dies one year later but the bond continues with Karen as the surviving life assured. In 2021/22 the trustees encash the bond. The gain is chargeable as follows:

- 50% on the trustees
- 50% on Karen

The 'dead settlor' provisions are becoming increasingly irrelevant, but state that If both the trust and the policy were in existence before 17 March 1998 and at least one of its creators was an individual, and one of the creators died before 17 March 1998. Then, provided the policy has not been varied on or after 17 March 1998 to increase benefits or extend its term, there is no charge on the trustees.

Given that the tax charge might fall on the settlor or on the trustees we need to consider both scenarios when assessing the tax situation.

1. Individuals

With an onshore bond, in broad terms,

- Basic rate taxpayers are not subject to further tax on the gain
- Higher rate taxpayers are subject to 20% tax on the gain
- Additional rate taxpayers are subject to 25% tax on the gain

With an offshore bond, an individual can be charged income tax at nil if the personal allowance is available; starting rate 0%; basic rate 20%, higher rate 40% and additional rate 45%. Also, from 6 April 2016, a tax-free personal savings 'allowance' (PSA) of £1,000 was introduced. The use of the word 'allowance' is misleading as it is, in fact, a zero rate tax band. If, however, any of the individual's income is higher rate income, then the allowance is reduced to £500. If any of the income is additional rate income, then the allowance is nil.

With both onshore and offshore bonds, a gain can push a basic rate taxpayer into higher rate, or a higher rate taxpayer into additional rate.

Top Slicing Relief (TSR) may therefore assist in reducing the rate of tax charged by applying a spreading mechanism. Even when the gain is all in higher rate, TSR may still be available thanks to a quirk in the legislation. TSR does not apply to personal representatives or trustees.

If a bond investment shows a loss on the occurrence of a final chargeable event, it will only be possible to offset this to the extent that there have been chargeable event gains in an earlier year (s 539 of Income Tax (Trading and Other Income) Act 2005). Therefore, if there is an investment for (say) £100,000, there are no withdrawals and encashment proceeds for £90,000, there is no loss and instead this represents a nil gain for chargeable event purposes. However, 'deficiency relief' under S539 may be available (to individuals only, not trustees), when a policy comes to an end. This is given as a tax reduction from the individual's income tax liability for the year, but unless income is liable at higher rate or dividend upper rate (not additional rate) on some income, there will be no tax reduction and deficiency relief will be of no benefit.

Entitlement to deficiency relief arises as follows:

- the calculation of the gain on the final chargeable event (death, maturity, full surrender) shows a negative amount
- one or more gains arose on 'excess events' in earlier tax years on which the same individual was liable, and
- the individual is the chargeable person (i.e. would have been liable had the calculation shown a gain)

The amount of deficiency relief will be the lesser of the deficit calculated in the final chargeable event calculation, and the total of gains on previous 'excess events' which formed part of the total income of the same individual who is now benefiting from the relief.

2. Trustees

Basic rate applies on gains up to £1,000, where this hasn't already been set against other non-savings income, otherwise the rate applicable to trusts applies (45%) meaning that a 25% liability arises for a UK bond. If the withdrawal amount is then distributed to beneficiaries, no further tax would be payable on this capital receipt. As mentioned above, TSR does not apply where trustees are liable.

Consider a will trust where UK resident trustees are contemplating an encashment. Any encashment gain cannot be charged on the settlor because he/she is deceased. Therefore the trustees will be taxed as outlined above. Alternatively, the trustees could keep the bond intact and assign segments of it by way of gift, to a beneficiary or beneficiaries. The assignment would not constitute a chargeable event. If the beneficiary later encashes then the gain will crystallise on the beneficiary. TSR will be available to the beneficiary back to inception of the bond.

It should be borne in mind that any withdrawal of capital, if distributed onwards to beneficiaries, may need to be notified to HMRC on form IHT100 and 100c.

E.2 Interest In Possession (IIP) Trusts

Of the three main types of investment-wrapper discussed in section D above, only collectives produce an income and therefore collectives are often the preferred choice for use with IIP trusts in circumstances where one or more beneficiaries are entitled to income (though please note the comments in

E.1.2 above regarding the tax aspects of capital withdrawals). The IIP taxation of interest, dividends and capital gains is covered in C2.2 and C3.1.

Investment bonds are non-income producing and withdrawals are a return of capital not ‘income’. If a beneficiary is only entitled to income, then the trustees should bear in mind that an insurance bond is generally not appropriate. Regular withdrawals from a bond may erode the capital payable to the remaindermen on the life tenant’s. The withdrawals could be taxed as income by HMRC.

But, if there is a clause in the trust deed giving the trustees power to pay capital to the life tenant then an insurance bond would therefore be a potential investment if the trustees so choose. Also, in cases where one beneficiary is entitled to income and others entitled to capital, then the trustees could diversify the trust fund, perhaps by investing in a mixture of OEICs to suit the income needs of one beneficiary, and insurance bonds to provide capital for the others.

E.3 Bare Trusts

Offshore bonds may be particularly suitable investments for young beneficiaries. Consider a bare trust set up by a parent for a child. In this situation, any investment income would normally be taxed as the parent’s if it exceeded the £100 rule. A non-income producing bond would overcome this problem. While the child is under 18, either no withdrawals could be taken or they could fall within the 5% allowance. If there are no chargeable event gains then no tax liability arising for the parent. Once the beneficiary reaches 18, then the adult child would then be the taxable person and chargeable event gains could be sheltered by the personal allowance, the £5,000 0% starting rate for savings income and the Personal Savings ‘Allowance’.

If a bare trust for a child arises on death of a parent or grandparent then the child is taxable from inception regardless of whether the gain arises when the child is under or over 18. That is typically beneficial from a tax perspective given that children, just like adults, have a personal allowance, and savings allowances.

Remember also that the intestacy rules in Scotland & Northern Ireland are such that where trusts are established for children who have lost a parent, the terms of those trusts will be such that they will be treated as bare trusts for tax purposes.

Note that the £100 rule does not apply in a grandparent/grandchild situation.

A final word on bare trusts, with bare Discounted Gift Trusts, assessing the chargeable event gain is relatively complex where a chargeable event gain arises in situations other than in the tax year following that in which the donor dies.

E.4 Charities

UK based charities are entitled to tax reliefs and so do not pay tax on most investment income and gains providing these sums are used for charitable purposes. The charity must be established for charitable purposes only, be registered with the Charity Commission (or similar regulator) and be recognised by HMRC.

Incorporated charities have a legal identity and investments can therefore be held in the name of the charity.

Unincorporated charities, such as trusts and associations, do not have their own legal identity and their investments must therefore be held in the names of the trustees or their nominees. The investment powers of both types of charity will be defined by their governing documents, and these normally confer wide powers which would override any statutory restrictions – though the Trustee Act 2000 also permits great latitude.

Exercising its power under s25 of the Charities Act 1993, the Charity Commission has established two types of investment scheme for charities, Common Investment Funds ('CIFs') and Common Deposit Funds ('CDFs'). CIFs are collective investment schemes with defined investment objectives, often with an emphasis on income. CDFs are deposit-taking schemes which place the money they receive on deposit in the money market. The pooling of such monies, usually for relatively short duration, should secure a higher rate of interest for the depositing charities than would be obtainable by them individually. This makes them particularly attractive to smaller charities.

Both CIFs and CDFs are pooled funds which are charities themselves and enjoy the same tax status as other charities.

The charity commission has published CC14 “Charities and investment matters: a guide for trustees”. The aim of this guidance is to support charities and their trustees in confidently making decisions about investments that comply with their duties. The guidance contains the following matters which are of particular relevance to financial advisers.

- The purpose of financial investment is to yield the best financial return within the level of risk considered to be acceptable.
- Can all charities make financial investments? Yes.
- Charities may also invest to directly further their aims in addition to achieving a financial return – this is ‘programme related investment’.
- If the investment doesn’t fit wholly within the above two categories, then the charity can make a ‘mixed motive investment’.
- Trustees must select investments that are right for their charity; this means taking account of:
    - how suitable any investment is for the charity.
    - the need to diversify investments (legal requirement).
- Trustees must take advice from someone experienced in investment matters unless they have good reason for not doing so (legal requirement).
- Charities can invest ethically to reflect its values and ethos even if the investment might provide a lower rate of return. The trustees must however justify this.
- Trustees should be clear about the charity’s investment objectives. For example the objective may be to maximise income, preserve capital or ensure stability of income.
- Trustees must review investments from time to time (legal requirement).

- A charity should have a written investment policy and it will usually include the following information – scope of its investment powers; investment objectives; attitude to risk; how much is available for investment, timing of returns and liquidity needs; preferred types of investment (including ethical considerations); who can take investment decisions; benchmarks and targets; reporting requirements for investment managers.

- Trustees should be aware that some investments may have tax implications for the charity. Although tax legislation places no restrictions on what a charity can invest in, some investments may be treated as non-qualifying expenditure, with tax consequences. The charity may lose exemption from tax on an amount of income or gains equal to the amount invested. Trustees should refer to HMRC's guidance. HMRC Charities: detailed guidance notes. Annex III:

- Approved charitable investments and loans. Charities considering investments which may be treated as non-charitable expenditure should bear in mind that they will need to be able to satisfy HMRC that the investments are made for the benefit of the charity and are not for the avoidance of tax, whether by the charity or by any other person.

- Collective investment schemes (pooled funds) – what are the benefits for charity investors? This form of investment can help charities diversify their investments and thus reduce their investment risk in a more cost effective way than investing directly in individually selected investments. Such schemes can form part, or all, of their investment portfolio, depending on the charity's investment policy. A collective investment scheme that many charities use is called a common investment fund (CIF). CIFs are regulated charities in their own right and only charities established in the United Kingdom can invest in them. They give charities of all sizes the ability to invest in a tax efficient way in a range of investments to achieve a professionally managed, diversified and balanced portfolio.

Note that Gov.UK contains “Charities: detailed guidance notes”. Included in this section is “Annex vi: life assurance and capital redemption products”.

This annex details why there are a number of problem areas about the suitability of insurance policies as investments for charities, and highlights that “the tax implications can be complex for both the charity and its donors.” This derives from the fact that HMRC consider premiums paid by charities on insurance policies are non-charitable expenditure. Consequently, the “general” charitable exemption from income tax and capital gains tax will not apply to such bonds. In addition tax exemption on other charitable income will be lost. It is therefore clear that investment bonds and capital redemption policies, whether onshore or offshore, are unsuitable investments for charity trustees.

Precedents

1. Trust fact-find for professional trustees
2. Financial adviser’s trust fact-find
3. Financial adviser’s report on referred trust
4. Minutes of trustees’ meeting

1. Trust Fact-Find for Professional Trustees

Client:

Part 1: Trust Information

Title of Trust

Designation

Settlor's name

Settlor's address

Type of Trust	□ Vested interest	□ A&M	□ Discretionary
	□ Other		
Trust instrument	□ Settlement Deed	□ Will	□ Intestacy
	□ Deed of variation		
Controlled trust?	□ Yes	□ No	
Settlor's side letter?	□ Yes	□ No (if yes, copy attached)	
Settlor-interested trust?	□ Yes	□ No	

Number of trusts settled & dates

Date of Deed/ Will

Date of death

Date of Probate

Part 2: Trustees

Trustees' decisions □ All trustees must consent □ Minimum of …trustees must consent

Title	1.	2.
Surname		
Forenames		
Address		
Postcode		
Home phone/mobile		
Work phone		
Email address		
Date appointed		

Title	1.	2.
Surname		
Forenames		
Address		
Postcode		
Home phone/mobile		
Work phone		
Email address		
Date appointed		

Part 3: Beneficiaries

Life Tenant?

Name ....

Address ....

Home phone/mobile ....

Work phone ....

Occupation ....

Date of birth ....

Marital status ....

Previous marriage? ....

Children ....

NI number ....

Health ....

Accountant ....

Solicitor ....

Tax district/ref ....

Bankers ....

House owned by ....

Employment ....

Financial situation and requirements ....

Notes/other facts ....

Residuary beneficiaries/remaindermen

1. Name

Address

Home phone/mobile

Work phone

Occupation

Date of birth

Marital status

Previous marriage?

Children

NI number

Health

Accountant

Solicitor

Tax district/ref

Bankers

House owned by

Employment

Financial situation
and requirements

Notes/ other facts

Ultimate default ben.

1. Name

Address

Home phone/mobile

Work phone

Occupation

Date of birth

Marital status

Previous marriage?

Children

NI number

Health

Accountant

Solicitor

Tax district/ref

Bankers

House owned by

Employment

Financial situation
and requirements

Notes/ other facts

Ultimate default ben.

Part 4: Trust Terms

Trust objectives □ Provide for spouse/civil partner

□ Provide for children □ Provide for g'children

Other objectives ....

Investment powers ....

Power to advance capital? □ Yes □ No

Power to delegate? □ Yes □ No

Trust income □ Accumulated □ Payable to: ....

Income mandated to ....

Investment policy □ Capital growth □ Income & growth

□ Maximum income

Investment service □ Advisory □ Discretionary

Investment policy □ Very cautious □ Cautious

□ Average □ Experienced

Invs in nominee co □ Yes □ No

Securities held by: ....

Part 5: Trust Capital

Bank a/c

Building Soc a/c

Stock Exch Inv. □ As per Trust Accounts □ As per attached valuation

Other investments

Debts/ liabilities

Anticipated capital additions or withdrawals

Part 6: Trust Contacts

Accountants

Bankers

Stockbrokers

Insurance brokers

Other contacts

Part 7: Tax and Other Information

Tax district

Tax Returns done by

Accounts done by

Settlor's tax status □ UK resident □ UK domiciled

Other tax status

10 year anniversary

Vesting dates

Advances As shown in Trust Accounts

Gains held over?

Tax pool carried forward?

Previous gifts made by settlor?

Accumulation period ends

Perpetuity period ends

Trusts of Land Act *

Special instructions/notes

TRS details

FICO number:

Registered charity no:

FACTFIND COMPLETED BY:

SIGNATURE: DATE:

NB. Please ensure that a copy of the trust document and copies of any deeds of retirement and/or appointment are attached.

* *Trusts of Land and Appointment of Trustees Act 1996 – a reminder that it might be desirable, for example, to follow the fairly common practice of excluding s11 of the Act.*

2. Financial Adviser’s Trust Factfind

Referring fee-earner		
Financial adviser instructed		
Name of Trust		
Name of settlor		
Trust created by	□ Deed □ Will □ Intestacy (please attach copy+Probate)	
Type of Trust	□ Bare □ Interest in Possession □ A&M □ Discretionary	
Date of Deed or Will	Date of death:	Date of Probate:
Trustees	□ Yes □ No	
TRS details		
Controlled trust?	□ Yes □ No	
Beneficiaries	Age(s) Tax rate Tax residence Life tenant: Remaindermen: Appointed Class:	
Trust objectives	Date of death: □ spouse □ children □ grandchildren	
Investment objectives	□ Growth □ Income & Growth □ Maximum income	
Investment powers		
Settlor’s other intentions		
Time horizon of Trust		
Existing Trust assets	(Please attach schedule)	

Likely capital additions or withdrawals?	
Liquidity requirement?	
Income requirement?	
Is CGT a constraint?	
Power to advance capital?	
Previous year’s tax return	(please attach)
(Disc. and A&M trusts)	
Has income been paid to any of the beneficiaries?	
Attitude to risk Unlike individuals, trustees do not have an attitude to risk. Trustees must invest in a way that is suitable for the trust objectives bearing in mind the particular circumstances of beneficiaries. Returns should be maximised but without taking any undue risks.	□ Very cautious □ Cautious □ Average □ Experienced
Investments currently managed by	
Dated	

3. Financial Adviser’s Report on Referred Trust

Referring fee-earner	
Financial adviser instructed	
Name of Trust	□ Bare □ Interest in Possession □ A&M □ Discretionary
Name of settlor	
Type of Trust	
Investment objectives	
Investment powers	
Income requirement	
Time horizon of Trust	
Current arrangements	
Investments currently managed by	
Discretionary or advisory?	
Policy statement in place?	
Date of last investment report	
Current capital value of investments	
Value of investments at inception	
% income actually being paid	
Comment	

Risk level of portfolio (scale of 1 to 10)	
Comment on risk level	
% investment split by asset type	
Comment on suitability	
Investment wrappers used	
Comment on suitability	
Tax considerations for Trust	
Tax considerations for beneficiaries	
TRS update	
Constraints on portfolio changes (CGT?)	
Provisional recommendation	
Dated:	

4. Minutes of Trustees' Meeting

XYZ Trust

Minutes of a meeting of the Trustees

held at ....

on ....

Present: ....

....

....

1. The minutes of the meeting of the Trustees held on .... were noted and approved
2. The report of ABC financial advisers on the status of investment markets and the performance of the trust portfolio was received and considered. It was noted that the capital value of the fund stood at £.........and the income paid to beneficiaries during the 12 months to .... amounted to £..............
3. Where appropriate [The cashflow projections provided by ABC financial advisers were noted and approved]
4. It was noted that the risk rating given to the investment portfolio by ABC financial advisers was on a (scale of 1 to 10) and it was agreed that this was appropriate having regard to the terms of the trust instrument.
5. It was agreed that having regard to tax and cost considerations the use of advisory/ discretionary investment management remained appropriate and that the most appropriate investment vehicles continued to be funds/ investment bonds/ individual securities and that an active/ passive/ mixed approach should continue to be adopted.
6. The position of the beneficiaries was considered and having regard again to the terms of the trust instrument it was agreed to...........
7. Having regard to the status of investment markets and the position of the beneficiaries it was agreed following discussion with ABC financial advisers that the following action should be taken....................

TRUST

SIFA Pro

INVEST

Published by SIFA Professional in partnership with Prudential part of M&G plc. Leatherhead House, Station Road, Leatherhead, Surrey KT22 7FG Tel: 01372 721172 www.sifaprofessional.co.uk

© SIFA Limited 2021 04/21

PRUAG02068 07/2021_WEB