# Trusts: a look at the income tax and capital gains tax benefits

***In the second of a series of articles, we look at some further tax advantages of trusts.***

In the last edition of Shipshape (*https://tinyurl.com/38z67sdm*), we discussed trusts and how they provide a method of making gifts for the benefit of others. These are put into the safe hands of trustees who look after the assets, providing income or benefits to beneficiaries, until such time as it's appropriate to close the trust. Trusts can be very useful for inheritance tax (IHT) purposes, but this isn't the only tax which makes them appealing.

**Income tax**

Trusts can be hugely beneficial for income tax purposes in the right circumstances. As long as a trust is not settlor-interested (broadly where the settlor or their minor children can benefit), payments made to a beneficiary from the trust are taxed at their marginal tax rate. This means lower tax-paying beneficiaries may have little to pay.

An example of this is where grandparents settle funds on trust for their grandchildren. Assuming the grandchildren have no other income, payments of up to £12,500 can be made for their benefit with no net tax paid on that income. This can be a very efficient way of funding school fees.

Parents normally need to wait until their children are over 18 to create a trust for their benefit without adverse tax consequences, but then a gift into trust could be made where the income is used for university fees – again at a tax-free or low tax rate.

Once the children or grandchildren finish education, the trust capital might be used to help towards a new home or held in trust to generate income, or for future beneficiaries.

**Capital gains tax**

One potential issue with creating a trust is having the cash resources to make a gift. However, the tax rules can help with this.

Rather than selling an asset to raise cash and suffering capital gains tax (CGT), assets can be gifted directly to a trust, and CGT hold-over relief used to defer the gain. Any CGT is then payable by the trustees instead when they come to sell in the future.

This works well for both rental properties and long-standing shareholdings where gains on a disposal could be high. As long as the assets produce an income stream for the trustees to use, and no disposal is required, the trust could continue to hold these assets.

Trustees have a CGT annual exemption, which is half that of an individual. Therefore, if we take the example of a shareholding, the trustees could slowly divest themselves of the shares using their exemption each year and diversify away from the gifted shares.

One further benefit is that if the trustees decide to distribute capital to a beneficiary, they can do this under the same hold-over rules. So, a further planning option is to distribute shares to a beneficiary who has no other gains. They can then sell them and use their full annual exemption.

**More details on trusts and estates from the Shipleys website at:** ***https://tinyurl.com/uc3496wt***

## Example

### The life of a shareholding trust

As an example of the life of a trust, a grandparent might do the following:

- **Create a trust with £300,000 of shares, with any gain 'held over'**
- **Use the income and some capital for the following 10 years to pay £20,000 per annum towards school and university fees, with little or no income tax or CGT required to be paid if within the relevant allowances**
- **After 10 years, assuming some growth, there might be, say, £270,000 left in the trust for the grandchildren who have now left university**
- **Each grandchild could have £135,000 to put towards a property purchase or to provide them with additional income until they need the capital.**

By this stage, the grandparent has made a gift of £300,000, which along with any growth is now outside their IHT estate. They have not paid income tax on, say, £100,000 of income over that period and have helped their grandchildren. This does assume roughly 3% growth and 3% gross income being generated.

The total tax saving for additional rate taxpayers here could be over £160,000 in IHT and income tax, plus any CGT savings, compared to making payments from after-tax income, or over £200,000 by doing nothing at all – all from a £300,000 gift.