BARE TRUSTS FROM THE PROSPECTIVE OF INCOME TAX, CAPITAL GAINS TAX AND INHERITANCE TAX

by Nicola Shaw

BACK TO BASICS

Taxation of Trusts Generally

"Just as a swimmer's environment is water, so a trust's environment is a fiscal system" (Hayton).

The advantages of the trust are threefold:

(i) the controlled distribution of private wealth;

(ii) flexibility of format; and

(iii) potential tax benefits.

When it comes to taxing trusts, there are a number of possible methods, but the overriding normative aim of the tax rules is to prevent any unacceptable tax avoidance without penalising the trust as a facilitative institution. In the UK we have largely opted for "personification", which means that we treat the trust as the taxable entity, a bit like a company, taxing the trustees, not as agent for the beneficiary, but as administrators of the trust.

However, when it comes to bare trusts the tax regime adopts a policy of essentially ignoring the existence of the trust. The trust is treated as transparent, allowing the Revenue to pierce the trust's veil and look through to the underlying beneficiaries. The trust might, therefore, just as well not exist for tax purposes.

This article will focus only on the bare trust and its liability to income tax, capital gains tax and inheritance tax. But first it is necessary to establish exactly what we mean by the term "bare trust".

<u>What is a bare trust</u>

Sometimes called a "simple trust", this trust enables the settlor merely to deposit property with a trustee (or nominee) without any complicated administrative or management scheme. The trustee is not faced with the burden of exercising any sort of discretion. The only duty with which he is entrusted is to hold the legal title to the property on behalf of the beneficiary and to convey it to the beneficiary if requested to do so.

An example of a bare trust would be where a settlor ("S") devises property to a trustee ("T") to hold on trust for a beneficiary ("B") absolutely. However, it should be noted that B must be "sui juris", in other words a person who is under no disability affecting his legal capacity to make conveyances of his property. Such a "disability" extends not only to persons of unsound mind, but also to infants.

Another example would be where S devises property to T to hold on trust for B1, B2 and B3 absolutely (where B1, B2 and B3 are sui juris).

It does not, however, include the situation where S devises property to T to hold on trust for B1 for life and thereafter for B2 absolutely. Here, B1 and B2 are entitled to the property **in succession**, and not **concurrently** as in the example above. As long as B1 is living, T is required to perform an active role and it will not be until the property is held for B2 absolutely that T's role will become passive and the trust will constitute a bare trust. This will be so even though B1 and B2 could, if both one mind and sui juris, break the trust and cause an absolute vesting of the trust property in them under the rule in <u>Saunders v. Vautier</u> (1841) Cr & Ph 240.

Likewise, if B's absolute entitlement is subject to some contingency (for example, on B attaining the age of 25) the trust will not be a bare trust until the contingency is satisfied even though B might still be sui juris.

<u>Income Tax ("IT")</u>

Prior to April 1996, the trustees of bare trusts would account for basic rate IT and then the beneficiary would receive a credit for the IT paid by the trustees to set against his own liability to IT (or in respect of which he might claim a repayment from the Revenue, if his own liability was nil).

However, the position now is that unless the trustees and the beneficiary elect that the trustees will make a return of the income and account for IT on it, the beneficiary, being absolutely entitled to the income, will be treated as receiving the income and will thus be liable to make the appropriate return of the income and pay IT on it. It should be noted that the beneficiary will be so liable in respect of any income which accrues to the trust, whether or not it is actually paid to the beneficiary by the trustees (see Baker v. Archer-Shee [1927 AC 844).

Capital Gains Tax ("CGT")

CGT is a tax on chargeable gains arising on the disposal of assets. As far as trusts are concerned, the principal divide for CGT purposes is between bare trusts and all other trusts. Section 68 of the Taxation of Chargeable Gains Act 1992 ("TCGA") defines settled property as "any property held in trust other than property to which s.60 applies". Section 60 TCGA states:

> "(1) In relation to assets held by a person as nominee for another person, or as trustee for another person absolutely entitled as against the trustee, or for any person who would be so entitled but for being an infant or other person under disability (or for two or more persons who are or would be jointly so entitled), this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the assets were the acts of, the person or persons for whom he is the nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly).
>
> (2) It is hereby declared that references in this Act to any asset held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the asset for payment of duty, taxes, costs or other outgoings, to direct how that asset shall be dealt with."

The concept of a bare trust for CGT purposes turns on the ability of the beneficiary to call for the trust property (i.e. sui juris beneficiaries), but then it extends the concept to those beneficiaries who would be so entitled were it not for their infancy or disability (i.e. their non-sui juris status). It also includes those beneficiaries who would be "jointly so entitled" to call for the trust property.

It is these latter two situations (non-sui juris beneficiaries and joint beneficiaries) which can cause the most difficulty in ascertaining whether a trust is bare for CGT purposes.

Non-sui Juris Beneficiaries

It is in the context of infant beneficiaries that the problems can arise. If property is held by trustees for an infant beneficiary absolutely, then for CGT purposes this will constitute a bare trust. However, if trustees hold property for an infant beneficiary absolutely, contingent upon the beneficiary reaching a certain age, then the trust does not fall within s.60 TCGA because the beneficiary's inability to request the trust property is not his infancy but his failure to satisfy the contingency.

It can be seen, therefore, that the CGT provisions slightly extend the trust law position, by including infant beneficiaries where there is no contingency to their future entitlement, but preserves the strict trust law position with regard to infant beneficiaries where their entitlement is subject to a contingency.

The subtlety of the difference can be illustrated by the following examples[*]:

(a) S devises property to T to hold for B absolutely;

(b) S devises property to T to hold for B absolutely, contingent upon B attaining the age of 18;

(c) S devises property to T to hold for B absolutely, contingent upon B attaining the age of 25.

Example (a) falls within s.60 TCGA because although B is only 10, he would be entitled to call for the property were he 18. Examples (b) and (c) do not fall within s.60 TCGA because B's entitlement is contingent, even though in example (b) B would actually be able to call for the trust property were he 18 because at that point he would have satisfied the contingency.

Joint Entitlement

The leading case on this issue is Booth v. Ellard [1980] STC 555. In this case, a number of shareholders in a family company transferred their shares to trustees on terms dictating the trustees' exercise of the shareholders' voting rights and other restrictions. The shareholders beneficial interests, however, were unaffected. It was held in that case that the trust did not constitute settled property for the purposes of

[*] In each example, B is 10 years old.

CGT, but rather fell to be treated as nominee property. Goulding J set out two conditions to be fulfilled if such property is to be considered as falling within s.60:

(i) the interests of the beneficial owners must be concurrent and not successive (enough property held for one beneficiary for life with remainder to another beneficiary absolutely will not qualify); and

(ii) the interests of the co-owners must be the same.

The effect of a trust falling within s.60 TCGA is that all gains and losses are treated as accruing to the beneficiary and not the trustee and any consequent liability for tax is the responsibility of the beneficiary. However, the transfer of trust property by the trustees to the beneficiaries is in effect tax-neutral for CGT purposes. CGT is a tax on chargeable gains arising on the disposal of assets. The transfer of assets to bare trustees will thus be treated as a disposal of those assets to the beneficiary. Any disposal of those assets by the trustees will be treated as a disposal by the beneficiaries.

<u>Inheritance Tax (“IHT”)</u>

Inheritance tax is a tax on transfers of value. Transfers of value may be either chargeable, exempt or potentially exempt in relation to IHT. The transfer of assets to bare trustees will be treated as an outright gift to the beneficiary and will therefore constitute a transfer of value falling within s.3A IHTA 1984 (potentially exempt transfers). On that basis, provided the donor survives the transfer by 7 years, the transfer will not give rise to an IHT charge. If the donor does die within 7 years of the transfer it will become chargeable to IHT.

In terms of any subsequent potential charge to IHT, because the beneficiary of a bare trust is absolutely entitled to the trust property it will, therefore, fall to be included in the value of the beneficiary’s estate on death and lifetime transfers of the trust property by the trustee will be treated as transfers by the beneficiary.

<u>Pros and Cons of Bare Trusts</u>

Let us return now to the three advantages of the trust outlined at the beginning of this article. The bare trust responds to the three elements with varied success:

(i) As a controlled method of distributing wealth it is redundant. The beneficiary will have full control over the trust property and the trustees will be largely superfluous, exercising little or no management or administrative powers.

(ii) In terms of the flexibility of format, the advantage of the bare trust is its ability to disguise the ownership of property and to enable the legal title to be held separately to the beneficial title.

(iii) As far as the tax position is concerned, the bare trust appears at first glance to be of very little benefit. The fiscal rules simply look through to and tax the beneficiary - the income and capital gains are treated as accruing to the beneficiary and for IHT purposes the trust property forms part of the beneficiary's estate. However, the potential advantages become apparent when one analyses the consequences in relation to a particular beneficiary. The usual tax rate for trusts, known conveniently as "the rate applicable to trusts", presently stands at 34%. The tax rate for a bare trust, on the other hand, will be the marginal rate of the beneficiary. So, if the beneficiary is a lower rate or nil rate taxpayer, the tax treatment of bare trusts is more favourable than that applicable to other trusts. Of course, if the beneficiary is a higher rate taxpayer, it will be less favourable. Furthermore, the beneficiary's personal allowance for IT and annual exemption for CGT may further reduce the tax burden - trustees have no annual allowance for IT because they do not constitute "individuals" and they qualify for only half the annual exemption for CGT purposes.

Conclusion

The bare trust is the most simple trust format. Its advantages as a facilitative institution are limited – it is considerably less effective as a means of the controlled distribution of wealth compared with other trust formats, but it does nonetheless provide a trust environment for property. In tax terms though, its advantages may be quite valuable. Although its existence is largely ignored, its tax treatment may be less harsh than that applicable to other trusts. For these reasons, the bare trust continues to be a viable potential tax planning vehicle.

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