CHAPTER 5

TRUSTS FOR THE VULNERABLE

5.1 Introduction

Special rules apply to reduce the tax liability for trusts set up for the benefit of a "vulnerable person". A "vulnerable person" is either:

a) A **disabled** person (including a person with a mental disorder); or FA2005, s.38

b) A relevant **minor** – meaning a person under the age of 18, **at least one of whose parents has died.** FA2005, s.39

To qualify for the special income tax treatment, the terms of the trust must provide for the beneficiary to receive the capital of the trust (together with any accumulated income) by the age of 18.

There are 6 steps in calculating the income tax liability for trusts where the beneficiary is a vulnerable person:

1) Calculate the income tax **liability for the trust using the normal rules** (i.e. assuming the beneficiary is not a vulnerable person). The legislation calls the resulting tax figure "TQTI", but for simplicity, we will call it "T". FA2005, s.27

2) Calculate the tax **liability of the vulnerable person assuming the trust income were to be treated as his own**. This is called "TLV 1". This stands for "tax liability for the vulnerable beneficiary". FA2005, s.28(3)

3) Calculate the tax **liability of the vulnerable person, ignoring the trust income**. This is called "TLV 2". If any trust income is distributed to the beneficiary in the year, it is **ignored** in computing "TLV 2". FA2005, s.28(2)

4) Take **"TLV 1" minus "TLV 2"**. This is called "VQTI" in the legislation, but again, for simplicity, we will simply call it "V". This is essentially the additional tax which the beneficiary would be liable for assuming the trust income accrued directly to him. FA2005, s.28(1)

5) Take **"T" minus "V"**. This is the **trustees' tax relief**. This is deducted from the trustees' tax liability as calculated in step (1). FA2005, s.26

6) **Deduct the tax relief** in step (5) from the trustees' tax liability as calculated in step (1) ("T"). The result is the revised trustees' tax liability.

In essence, the **tax liability of the trustees will be as if the trust income had accrued directly to the vulnerable beneficiary**. This enables the trust to take into account the beneficiary's personal allowances etc. This reduces the tax burden where the beneficiary is not a higher rate taxpayer.

These provisions give relief for **discretionary or A&M trusts only**. Where the beneficiary has an interest in possession in the trust (and the trust income thereafter flows through to the beneficiary by right), these rules do not apply and the trustees' tax liability is taxed in accordance with the rules in the previous chapter.

The special rules **do not apply where the settlor has an interest** (i.e. can benefit from) the trust. In this case the trust income is wholly taxed on the settlor (see the later chapter on this).

Illustration 1

The Morgan Will Trust was set up on 6 April 2010 on the death of Joe Morgan.

The trust is for the benefit of Joe's only son Luke. Luke is 15. The trust is discretionary until Luke reaches 18. The trust satisfies the conditions as being a trust with a vulnerable beneficiary.

The trust has the following income and expenses in 2010/11:

	£
Rental profits (net of expenses)	28,000
Bank interest (net)	9,600
UK dividends	4,500
Trust management expenses	(1,350)

Luke is still at school. His only income in 2010/11 is as follows:

	£
Wages from a part-time job at weekends / holidays	1,000
National Savings interest (gross)	400

This income is therefore wholly covered by personal allowances, so no liability arises.

We need to calculate the tax liability of the trustees.

Step (1)
Calculate trust tax liability using "normal" rules:

	Non savings	Interest	Dividends
	£	£	£
Rental income	28,000		
Bank interest			
(£9,600 x $\frac{100}{80}$)		12,000	
Dividends			
(£4,500 x $\frac{100}{90}$)			5,000
Gross trust income	28,000	12,000	5,000
Less expenses			
(£1,350 x $\frac{100}{90}$)			(1,500)
Income after expenses	£28,000	£12,000	£3,500

Tax	*£*
"Basic rate":	
£1,000 @ 20%	200
Rates applicable to trusts (RAT):	
£(28,000 – 1,000) @ 50%	13,500
£12,000 @ 50%	6,000
£3,500 @ 42½%	1,487
£1,500 @ 10%	150
	21,337
Less tax credits:	
Interest (£12,000 @ 20%)	(2,400)
Dividends (£5,000 @ 10%)	(500)
Tax payable by trustees ("T")	£18,437

Step (2)
Calculate Luke's tax liability if the trust income was deemed to have accrued to him personally.

	Non savings	Interest	Dividends
	£	£	£
Earnings	1,000		
Trust rental income	28,000		
National Savings Interest		400	
Trust bank interest			
(£9,600 x $\frac{100}{80}$)		12,000	
Trust dividends			
(£4,500 x $\frac{100}{90}$)			5,000
Net income	29,000	12,400	5,000
Less: Personal allowance	(6,475)		
Taxable income	£22,525	£12,400	£5,000

Tax	£
£22,525 @ 20%	4,505
£12,400 @ 20%	2,480
£2,475 @ 10%	247
£2,525 @ 32½%	821
	8.053
Less tax credits:	
Interest (£12,000 @ 20%)	(2,400)
Dividends (£5,000 @ 10%)	(500)
Tax payable by Luke ("TLV 1")	£5,153

Step (3)
Calculate Luke's tax liability ignoring trust income.

This is nil as all income is covered by PAs ("TLV 2")

Step (4)
"TLV 1" minus "TLV 2" = "V"

	£
"TLV 1"	5,153
"TLV 2"	Nil
"V"	£5,153

Step (5)
"T" minus "V"

	£
"T"	18,437
"V"	(5,153)
Trustees' tax relief	£13,284

Step (6): Trustees' revised tax liability

	£
"T" (from step (1))	18,437
Less: Trustees' tax relief (from step (5))	(13,284)
Revised trust liability	£5,153

Essentially these rules act to align the trustees tax liability with that which would have arisen had the trust income been received directly by the vulnerable beneficiary.

5.2 Claims and elections

There are two claims which must be made.

1. The "vulnerable person" election

This is a **joint election** by the **trustees and the beneficiary** (or a guardian or legal representative of the beneficiary) to HMRC to confirm that the trust is a "qualifying trust" and the beneficiary is a vulnerable beneficiary. The election is irrevocable and must state the date from which the election is to take effect. FA2005, s.37

The time limit for the election is **31 January after the end of the tax year following that in which it first takes effect**. This can be extended at the discretion of HMRC.

The election will run until either:

a) The beneficiary **ceases to be a "vulnerable person"** – for example, on attaining the age of 18; or
b) The trust is **no longer a "qualifying trust"** – for example, if the beneficiaries change; or
c) The **trust is wound up.**

If any of these events occur, the trustees must **notify HMRC within 90 days.**

2. *Claim for special tax treatment*

The special tax rules do **not** apply **automatically** – the relief must be **claimed** by the trustees. On making this claim, the trustees become subject to the rules as outlined above. FA2005, s.25

The **claim is made year-by-year** by the trustees via their self-assessment return. If a claim is not made by the trustees, the usual rules for taxing the trust will apply instead.

5.3 Special rules

If the **rules apply for only part of a year, trust income is apportioned** and the special rules only apply to income arising in that part of the year for which a vulnerable person election is made.

This may happen, for example, if the parent (or parents) dies during the year or if the beneficiary attains 18 during the year.

If a trust has beneficiaries who are "vulnerable" and beneficiaries who are not, again the trust income is **apportioned such that the special rules only apply to that part of the trust income which is allocated to a vulnerable beneficiary**.

This would apply, for instance, if a Will Trust has two beneficiaries, one under the age of 18 and one over 18.

5.4 Capital gains

If a qualifying trust (i.e. one with a vulnerable beneficiary) has capital gains, **CGT relief is also available.** FA2005, s.30

In this instance the trustees' liability to CGT is similarly reduced by the difference between;

a) the tax payable if the gains were charged on the vulnerable beneficiary; &
b) the tax payable if the gains were charged on the trust.

The effect is that the trustees' liability is the same as that which would arise if the gains were charged on the vulnerable beneficiary (thereby using the beneficiary's CGT exemption).