VULNERABLE BENEFICIARY TRUSTS

What is a Vulnerable Beneficiary Trust

A Trust (also referred to as a Settlement) is a legal structure whereby one or more individuals (known as the Settlors) transfer the legal ownership of financial assets or property (referred to as the Trust Fund) to another group of persons (known as the Trustees) to be held by the Trustees on behalf of and for the benefit of another person or persons (known as the Beneficiaries). The terms of the arrangement are set out in detail in the Trust Deed, which will specify under what circumstances the Trustees should distribute some or all of the Trust Fund, or the income arising from it, to the Beneficiaries.

A Vulnerable Beneficiary Trust (sometimes also referred to as a Disabled Trust) is a Trust set up for a Beneficiary who meets the legal definition of a Vulnerable Person, which (in brief) is as follows:

- a person who is mentally or physically disabled; or
- someone under the aged of 18 who has lost a parent through death.

They are most commonly used in situations where the Beneficiary would be unable to, or find it difficult to, manage assets for themselves and/or where it would be inadvisable (for reason of state benefits or care costs) for these assets to be owned directly by the Beneficiary themselves.

Where a Beneficiary of a Trust is ‘vulnerable’, the Trust will qualify for special tax treatment provided the terms of the Trust Deed fulfils certain criteria.

How does a Trust qualify as a Vulnerable Beneficiary Trust

For a Trust to qualify as a Vulnerable Beneficiary Trust, the Beneficiary themselves must firstly meet certain criteria, and secondly, the terms of the Trust must also fall within set parameters:

The Beneficiary

To be treated as a ‘Vulnerable Beneficiary’ for tax purposes, the principal Beneficiary of the Trust must fall into one of the following categories:

1) They are aged under the age of 18 and at least one of their parents has died;  
   OR

2) They are an adult and are in receipt of one of the following benefits:
   a) Personal Independence Allowance (daily living component or mobility component);
   b) a Disablement Pension;
   c) Disability Living Allowance (care component at highest or medium rate);
   d) Disability Living Allowance (mobility component at highest rate);
e) Attendance Allowance;

f) Armed Forces Independence Payment;

OR

3) They would be entitled to one of the above benefits if they were not in a state-funded institution (for example a hospital);

OR

4) They are incapable of administering their property or managing their affairs because of a mental disorder covered by the Mental Health Act 1983.

Terms of the Trust

In order to obtain more favourable treatment for both Capital Gains Tax and Income Tax, the terms of the Trust must ensure that any capital or income distributed during the Vulnerable Beneficiary’s lifetime must only be applied for their benefit. This does not mean that the Trustees are required to distribute income or capital to the Beneficiary, but rather that if they choose to make a distribution, it must only be to the Vulnerable Beneficiary (or for their benefit) and not to any other person named in the Settlement.

What are the Tax Implications

The special tax treatment of a Vulnerable Beneficiary Trust aims to tax the income and gains arising from the Trust Fund as if the Beneficiary’s own allowances, reliefs and tax rates applied, and to ensure that, for Inheritance Tax purposes, the 10 Year Charges and Exit Charge, that affect most other Trusts, do not apply. The effects are as follows:

Inheritance Tax

The initial transfer of assets by the Settlor(s) into the Trust would be treated as a Potentially Exempt Transfer. In other words, there would be no charge to Inheritance Tax unless the Settlor(s) failed to survive the gift into the Trust by 7 years (in which case it would be taken into account when calculating the value of their Estate for Inheritance Tax purposes).

During the lifetime of the Trust there would be no Inheritance Tax charges, but on the Beneficiary’s death, the Trust Fund would be treated as part of their Estate and aggregated to the value of their personal assets when calculating whether an Inheritance Tax liability arises. Any advances of capital to the Beneficiary throughout their lifetime would be treated as a ‘non-event’ for Inheritance Tax purposes.
Capital Gains Tax ("CGT")

The Settlor(s) will potentially incur a CGT charge (at their own applicable personal rates) if assets other than cash (such as investments or property) are transferred into the Trust as this will be viewed as a disposal for CGT purposes. Similarly, the Settlor(s) may also incur a CGT charge if they sell investments in order to place cash into the Trust, depending on the accumulated gains on those investments and whether their full CGT annual exemption is available. The Settlor(s) should therefore take advice from their Accountant and investment manager on this point before making any sales or transferring assets to the Trust.

However, throughout the lifetime of the Trust, the Trustees will receive special treatment, and any CGT will be calculated at the Vulnerable Beneficiary’s rates, rather than the (usually) higher Trust rates. Consequently, if the Beneficiary would only be liable to CGT at 10% on investment gains and 18% on property gains, then the Trustees will also be charged at 10% and 18% rather than the usual Trust rate of 20% and 28%. Moreover, the Trustees will be able to benefit from the Beneficiary’s larger CGT annual allowance (which is double that of a Trust).

Income Tax

Similar rules as to the CGT regime will apply. That is to say the Trustees will be taxed at the Beneficiary’s tax rate and the higher Trust Rate (38.1% on dividends and 45% on all other income) will not apply.

How to obtain the Special Tax Treatment and protect the Vulnerable Beneficiary

If the Beneficiary qualifies as a Vulnerable Beneficiary, then the special tax treatment for the Trust can usually be obtained if the Trust Deed is drafted as a unique mixture of an Interest in Possession Trust (where the Beneficiary has a right to just the income) and a Discretionary Trust (where the Trustees decide what capital and income to distribute).

In a standard Vulnerable Beneficiary Trust, the Beneficiary would usually be named as the principal beneficiary, and during their lifetime they would be the only person who would be entitled to either the income or capital of the Trust (thus protecting their position, and ensuring that the Trust qualifies, from a tax perspective, as a Vulnerable Beneficiary Trust). However, the Trustees would normally retain a discretion over whether any income or capital is distributed to the Beneficiary, thus avoiding any problems should the Beneficiary be in receipt of means-tested benefits or unable to manage cash. The Trustees would also have the power to make payments on the Beneficiary’s behalf (e.g. to pay for accommodation or care costs) without any cash passing directly to the Beneficiary. Following the death of the Beneficiary, the remaining assets would be divided between the other beneficiaries named in the Trust Deed (either at the discretion of the Trustees or as stipulated in the Deed).
The Trust would therefore provide an income or capital flow, if required, to the Vulnerable Beneficiary, whilst ensuring that the underlying assets were not in the direct control of Vulnerable Beneficiary (if their capacity or means-tested benefits were an issue), and simultaneously avoiding the normal punishing tax regime applicable to most trusts. The Trust is therefore both a cost effective and tax efficient way of protecting assets without depriving a vulnerable person of the financial support they may need.

August 2016

FURTHER HELP

Our Private Client Team would be happy to answer any specific queries you may have or assist with the drafting and setting up of a Vulnerable Beneficiary Trust. Please contact Nicholas Barlow, Olivia Meekin, Richard Clapham or Sarah Budibent on 020 7404 7001 or via our website (www.mww-llp.com).

As with all of our downloads, this document is intended as a guide. Monro Wright and Wasbrough LLP remain at your disposal should you require further consultation. If you would like further advice, please click here and you will be redirected to our Private Client website page.