7. Trusts for disabled and vulnerable beneficiaries

7.1 Overview

Trusts can be used to safeguard property for a person in vulnerable circumstances and to ensure it is actively and prudently managed even at times when a vulnerable or disabled beneficiary is unable to do so themselves. The tax system recognises this to some extent and accords to certain trusts that are set up primarily for vulnerable or disabled beneficiaries a tax treatment that is more benign that that applying to most other trusts.

Essentially, this special tax regime aims to treat the trust property and income for tax purposes as belonging to the beneficiary, with the result that – for income tax and capital gains tax purposes – the rates, allowances and exemptions applied are those appropriate to the individual beneficiary rather than the trustees; and similarly the trust property is charged to inheritance tax as though the beneficiary had a life interest, even if the trust itself is discretionary.

The types of trust to which this favourable treatment applies are trusts for bereaved minors and disabled individuals, for which distinct rules apply for income tax and capital gains tax on the one hand, and inheritance tax on the other. Bereaved minors are persons under 18 at least one of whose parents has died, and "disabled person" means someone who is unable to manage their affairs by reason of mental disorder, or someone in receipt of a range of social security benefits (or who would be entitled to those benefits but for certain reasons, such as being accommodated at public expense).

While the inheritance tax legislation for disabled trusts dates back much further, the income tax and capital gains tax regime for "vulnerable trusts" was introduced by FA 2005. Changes in 2006 then brought in provisions enabling a person to settle their own property in a trust for a foreseeable time when they expect to become disabled (see **7.5.3**).

Nevertheless, the class of beneficiaries able to qualify as "disabled" was then too circumscribed to enable many who needed to take advantage of the special tax rules to do so, while opening the regime up to many more who did not particularly need to use it. The changes in 2013 and 2014, therefore, which followed the Welfare Reform Act 2012 adjustments to the welfare system for disabled benefit claimants, have been welcome in extending the special treatment to a range of other types of beneficiary who need the protection it offers but were not able to access it before. See further **7.2.1**.

In the sections which follow we consider in greater detail:

- the meanings of the terms "vulnerable person" and "disabled person" (**7.2**);
- the conditions a trust must fulfil in order to qualify for tax treatment as a vulnerable trust (**7.3**);
- how the special tax treatment works (**7.4**); and
- the inheritance tax rules for disabled trusts and self-settlements by a settlor who is expected to become disabled (**7.5**).

In **7.2.3**, a list is given of the social security benefits, receipt of (or, in some cases, underlying entitlement to) which enables a person to qualify as "disabled".

7.2 Definitions and meanings – "vulnerable person", "disabled person", "relevant minor"

7.2.1 Introduction

In this section we consider the meanings assigned, for the purposes of the legislation on disabled and vulnerable trusts, to "vulnerable person" and "disabled person".

Broadly, the definition of "vulnerable person" includes both "disabled person" and what the legislation calls a "relevant minor" – i.e. an individual who is under 18, and at least one of whose parents has died. A "disabled person" is defined as one who is:

- incapable of administering his or her property or managing his or her affairs because of "mental disorder" within the meaning of the Mental Health Act 1983 (see **7.2.3**); or
- in receipt of certain social security benefits (see **7.2.2**).

The definition of "disabled person" was very considerably broadened by amendments made to the original provisions by FA 2013 and FA 2014 following the changes to the social security system brought in by the Welfare Reform Act 2012.

The reform of the taxation of trusts in 2006-07 had failed to make the system suitable for people whose disabilities led to their property and affairs being administered by trustees on their behalf. The circumstances in which a trust with a disabled person could qualify for vulnerable trust status were then so circumscribed that many opted instead for bare trusts, under which the beneficiary could call for the trust property to be distributed to them at any time. This was clearly unsuitable for those whose disability made them vulnerable to undue influence or abuse, but who were not able to qualify for "disabled person" treatment under the conditions then in force. The Welfare Reform Act 2012 brought about a number of changes to the social security system as it applied to disabled claimants, in particular the introduction of personal independence payment, which required consequential amendments to the tax legislation governing vulnerable trusts. Thus an opportunity arose to rethink just who such trusts were really intended to benefit, and how best they could be provided for. The tax regime was therefore extended to a wider range of beneficiaries by expanding the list of social security benefits receipt of which would qualify a person as "disabled".

Law: FA 2005, s. 23(7), 38, 39, Sch. 1A; FA 2013, s. 216 and Sch. 44, para 14, 19; Welfare Reform Act 2012.

7.2.2 Beneficiary with "mental disorder"

One limb of the definition of "disabled person" (see **7.2.1**) classes as disabled "a person who by reason of mental disorder within the meaning of the Mental Health Act 1983 is incapable of administering his or her property or managing his or her affairs".

The Mental Health Act 1983 (MHA), as amended by the Mental Health Act 2007, rather unhelpfully defines "mental disorder" as "any disorder or disability of the mind". The accompanying Code of Practice published by the Department of Health offers the following non-inclusive list of clinically recognised conditions that could fall within the definition:

- affective disorders, such as depression and bipolar disorder;
- schizophrenia and delusional disorders;
- neurotic, stress-related and somatoform disorders, such as anxiety, phobic disorders, obsessive compulsive disorders, post-traumatic stress disorder and hypochondriacal disorders;

- organic mental disorders such as dementia and delirium (however caused);
- personality and behavioural changes caused by brain injury or damage (however acquired);
- personality disorders;
- mental behavioural and disorders caused by psychoactive substance use;
- eating disorders, non-organic sleep disorders and non-organic sexual disorders;
- learning disabilities;
- autistic spectrum disorders (including Asperger's syndrome);
- behavioural and emotional disorders of children and young people.

Dependence on alcohol or drugs is not in itself a mental disorder, but can cause or be accompanied by one of the conditions that would qualify as such under the MHA. The Code of Practice gives, as examples of such conditions, withdrawal state with delirium or associated psychotic disorder, acute intoxication, organic mental disorders associated with prolonged abuse of drugs or alcohol.

Law: FA 2005, s. 38 and Sch. 1A, para 1(a); Mental Health Act 1983, s. 1

Guidance: Dept of Health, Mental Health Act 1983 Code of Practice, ch. 2

7.2.3 Beneficiary in receipt of certain social security benefits

Persons who are in receipt of any of the following social security benefits come within the definition of "disabled person":

- attendance allowance;
- disability living allowance care component at the highest or middle rate, or the mobility component at the higher rate;
- in Scotland, disability assistance for children and young people by virtue of entitlement to the care component at the highest or middle rate, or the mobility component at the higher rate;
- personal independence payment;
- an increased disablement pension;
- constant attendance allowance;
- armed forces independence payment.

A person may still qualify as disabled for these purposes if they are not in receipt of certain of the above benefits, but have an underlying entitlement to them, and payment has only ceased because they do not fulfil certain prescribed conditions as to residence or presence in the UK, or live in accommodation that is provided for them such as a care home, or are in custody. The benefits to which these exceptions apply are:

- attendance allowance;
- disability living allowance;
- disability assistance for children and young people;
- personal independence payment;
- constant attendance allowance.

Similarly, a person may still qualify as disabled if they would be entitled to armed forces independence payment, but payment of it has ceased on their being admitted to the Royal Hospital, Chelsea.

Law: FA 2005, s. 38 and Sch. 1A

7.3 Qualifying for vulnerable trust status

7.3.1 Introduction

The conditions which a trust must meet in order to qualify as a vulnerable trust differ, but only very slightly, depending on whether the trust exists for the benefit of a disabled person or a relevant minor (see **7.2.1**). In the two sections which follow, we consider each in turn – qualifying trusts for disabled people in **7.3.2**, and for relevant minors in **7.3.3**.

7.3.2 Qualifying trust for disabled person

The conditions that must be met during the lifetime of the disabled person (or, if earlier, until the termination of the trusts) if the trust is to be a qualifying trust are as follows:

- if any trust property is applied for the benefit of a beneficiary, it must be applied for the benefit of the disabled person; and
- either the disabled beneficiary is entitled to all the income arising from the trust property, or any such income that is applied for the benefit of a beneficiary must be applied for the benefit of the disabled person.

Those conditions are not breached if:

- the trustees have powers of advancement under the Trustee Act 1925, s. 32 or similar such powers, even without the restriction in s. 32(1)(a) that any such advancement must be limited to the share, or prospective share, in the trust of the recipient of the advance;
- the trustees use that power to apply for the benefit of someone other than the disabled beneficiary amounts up to the annual limit of £3,000 or (if lower) 3% of the maximum value of the trust property in the year (subject to revision by Treasury order).

The Treasury has power to amend the annual limit or to specify the circumstances in which such amounts may be spent, but as at the time of writing no such order has been made.

The meaning of "disabled person" is discussed in **7.2.1**ff.

Law: FA 2005, s. 34

7.3.3 Qualifying trust for "relevant minor"

To qualify as a trust for a "relevant minor" (see **7.2.1**), the trust must be:

- a statutory trust for the minor beneficiary under the rules of intestacy (Administration of Estates Act 1925, s. 46 and 47(1)); or
- set up under the will of a deceased parent of the minor beneficiary, or under the Criminal Injuries Compensation Scheme or the Victims of Overseas Terrorism Compensation Scheme.

The terms of the trust must secure that the minor beneficiary will become absolutely entitled to the trust property and its income, including any accumulated income, on attaining the age of 18; and until that time:

- any trust property that is applied for the benefit of any beneficiary must be applied for the minor beneficiary during his or her lifetime; and
- either the minor beneficiary is entitled to all the income arising from the trust during his or her lifetime, or any such income that is applied for the benefit of a beneficiary must be applied for the minor beneficiary while he or she is living.

As with disabled trusts, those conditions are not breached by the trustees having powers of advancement which they may use to advance amounts up to the annual limit to someone other than the minor beneficiary up to the annual limit of £3,000 or 3% of the maximum value of the trust property in the year, whichever is lower. Again, the Treasury may alter the annual limit or specify the circumstances in which such amounts may be spent, but has not yet done so as at the time of writing.

Law: FA 2005, s. 35, 36.

7.4 Income tax and capital gains tax treatment of qualifying trusts

7.4.1 Introduction

If the trustees and beneficiary of a vulnerable trust wish to take advantage of the favourable tax treatment for income tax and capital gains tax accorded to such trusts for a particular tax year, two conditions must be fulfilled:

- the trustees must be holding trust property during that year for the benefit of a vulnerable person (see **7.2**); and
- a vulnerable person election (see **7.4.2**) must be in force for all or part of that year.

Then if:

- income arises (or is treated as arising) to the trustees in that year from property held on qualifying trusts (see **7.3**) for the benefit of a vulnerable person (see **7.2**); and
- the trustees make a claim for special tax treatment,

the special tax treatment described in **7.4.3** applies for the year, provided that the settlor is not deemed to retain an interest in the trust property for the purposes of the settlement anti-avoidance legislation in ITTOIA 2005, s. 620, 624 and 625.

The special tax treatment applied to such trusts aims to ensure that the income of the trust is taxed, broadly, at the rate applicable to the individual beneficiary rather than to the trustees, although what should be comparatively simple look-through arrangements are tied up in some very abstruse calculations prescribed by the legislation (see **7.4.3**).

Law: FA 2005, s. 24, 25.

7.4.2 Vulnerable person election

Trustees who hold trust property on behalf of a vulnerable beneficiary (see **7.2.1**) and the beneficiary may jointly make a "vulnerable person election" in relation to the trust, if the trust itself is a "qualifying trust" (see **7.3.2** and **7.3.3**).

A vulnerable person election is made by completing form VPE1 (available online here [Trusts and estates: vulnerable person election form (VPE1) - GOV.UK (www.gov.uk)]) giving details of the trust and confirming that it is "qualifying", the trustees, the vulnerable beneficiary and his or her entitlement under the trust, and any persons connected with the trust. The beneficiary must also authorise the trustees to make any claim for any tax year that they consider appropriate.

The election must specify the date from which it is to take effect and be given to HMRC not later than 12 months following the 31 January after the end of the tax year in which the specified date falls.

Example

In his will, Jack set up a trust for the benefit of his disabled daughter Patricia, appointing his solicitors as trustees. Jack died on 31 May 2021. The trustees together with Patricia drew up a vulnerable person election designating Patricia as a vulnerable person, and specifying Jack's date of death as the effective date.

The specified date (being Jack's date of death) falls within the tax year 2021-22. The vulnerable person election must therefore have been submitted to HMRC within 12 months of 31 January 2023, i.e. on or before midnight on 31 January 2024.

Once made, a vulnerable person election is irrevocable, but it is no longer effective if:

- the person in relation to whom it is made ceases to be a vulnerable person; or
- the trusts in relation to which the election is made cease to be "qualifying trusts"; or
- the trusts are terminated, for example if the vulnerable beneficiary dies.

If such an event occurs, the trustees have 90 days from becoming aware of it to notify HMRC that the election is no longer effective.

Law: FA 2005, s. 37

Enquiries

On the making of a vulnerable person election, HMRC have power to make enquiries into the circumstances surrounding it. They may serve notice on the trustees or on the vulnerable beneficiary who made the election requiring them to provide with such particulars as they may reasonably require, within a time limit which must not be less than 60 days, in order to determine:

- whether the beneficiary who is the subject of the election is indeed a vulnerable person, or
- whether the trusts are indeed qualifying trusts, or
- whether, since the effective date of the election:
  - the beneficiary has ceased to be a vulnerable person, or
  - the trust has ceased to be qualifying, or
  - the trust has been terminated.

If HMRC decide that any one or more of those requirements have not been fulfilled, they may give notice to the trustees and the vulnerable beneficiary that the vulnerable person election either never had effect, or has ceased to have effect from a specified date.

Anyone aggrieved by such a determination by HMRC may appeal against it by notice, which must be given to HMRC within 30 days of the date of the determination.

Any adjustments made for giving effect to the determination, whether by discharge or repayment of income tax or capital gains tax or by assessment, may be made despite any time limit.

Law: FA 2005, s. 40

7.4.3 Qualifying trusts – income tax treatment

As shown at 7.4.1, the object of the special income tax treatment is to ensure that the trustees of a vulnerable trust pay broadly the same amount of income tax as the vulnerable beneficiary would have owed had the income been his or hers. The commentary and example which follow assume a basic knowledge of how trust income is taxed in general.

The special income tax treatment of vulnerable trusts works by giving the trustees a tax relief equal to the difference between (a) what the trustees' liability would have been normally, without the special tax treatment ("TQTI") and (b) the amount of income tax which the vulnerable beneficiary would have owed if the trust income were included in his/her own income ("VQTI").

VQTI is calculated by subtracting TLV2 from TLV1, where:

- TLV2 represents the income tax liability of the vulnerable beneficiary without counting any of the trust income that is distributed to him/her during the tax year, or any relief that is given by deduction from the beneficiary's tax bill (such as married couple's allowance); and
- TLV1 represents the liability of the vulnerable beneficiary assuming that his/her income includes the income arising to the trustees during the tax year.

Example

Under the terms of Harry's will, his residuary estate is set aside on qualifying trusts (see **7.3.2**) for his disabled daughter Sally, whose only other income is a salary of £10,000 a year from a part-time job.

The income of the trust for the year 2022-23 (for which a vulnerable person election (**7.4.2**) is in force) is as follows:

TQTI Calculation		
	£	**£**
Interest on trust bank account	20,000	
UK dividends		50,000
<u>**Application of tax rates**</u>		
£1,000 standard rate band	@ 20%	200
£19,000 interest at trust rate	@ 45%	8,550
£50,000 at trust dividend rate	@ 39.35%	19,675
		28,425
TQTI total		**28,425**

VQTI, Sally's income tax liability if the trust income formed part of her own, is TLV1 less TLV2.
TLV2 is Sally's income tax liability if the £10,000 salary that Sally earns from her part-time work were her only income. As it is covered by her personal allowance, her tax liability on it is nil.

TLV1 (Sally's total income tax liability for 2022-23 if the trust income were added to her own) is calculated as follows:

	£	£	£
Salary (Sally)	10,000		
Interest bank account income (trust)		20,000	
UK dividends (trust)			50,000
Less: personal allowance	(10,000)	(2,570)	
Total	**0**	**17,430**	**50,000**

<u>Application of tax rates</u>

Starting rate for savings	5,000	@ 0%	0
Personal savings allowance	500	@ 0%	0
Remaining savings income taxed at basic rate	11,930	@ 20%	2,386
Personal dividend allowance	2,000	@ 0%	0
Dividend income taxed at basic rate	18,270	@ 8.75%	1,599
Basic rate band	**37,700**		
Remaining dividend income at higher rate	29,730	@ 33.75%	10,034
	67,430		
Total tax liability (TLV1)			**14,019**

<u>The relief claimable by the trustees</u>

TQTI	28,425
Less VQTI (made up of TLV1 (£14,019) less TLV2 (nil))	(14,019)
Amount by which trustees' income tax liability to be reduced	**14,406**

END EXAMPLE

Where the trust income is partly from qualifying trusts and partly non-qualifying, the management expenses that the trustees are able to deduct are apportioned, and only the proportion of expenses attributable to the qualifying trusts are taken into account for calculating TQTI.

Section 629 of ITTOIA 2005, which deems income arising from a trust to be that of the settlor for tax purposes if any of it is paid to a minor, unmarried child of the settlor during a tax year, does not apply if:

- payment to the child is made out of qualifying trust income, and
- the child is a vulnerable person, and
- the trustees have successfully claimed special income tax treatment for the year.

Where a vulnerable person election has effect for only part of a year, then the calculations described above are based on the income from the qualifying trust that arises to the trustees for that part of the year.

Law: FA 2005, s. 26-29

Guidance: TSEM 3460ff

7.4.4 Qualifying trusts – capital gains tax treatment

The tax treatment of chargeable gains accruing to the trustees of a qualifying trust follows a similar pattern to the income tax treatment described in **7.4.3**, but with slight differences depending on whether the vulnerable person is resident or non-resident in the UK.

The special treatment for CGT purposes applies for a tax year if:

- chargeable gains accrue to the trustees of a qualifying trust for which a vulnerable person election is in force;
- the trustees would normally be liable to CGT on those gains;
- the trustees are UK-resident in any part of the tax year; and
- the trustees make a claim for special tax treatment for the tax year.

No claim for special tax treatment for CGT can be made for the tax year in which the vulnerable person dies.

If the vulnerable person is UK-resident, the special tax treatment of trust gains works as follows:

- calculate what the trustees' liability to CGT would be if there were no special tax treatment (TQTG);
- then deduct the additional tax to which the vulnerable beneficiary would be liable if the trust gains were imputed to him/her (VQTG).

VQTG is calculated by deducting the total amount of CGT to which the vulnerable beneficiary is liable in his/her personal capacity for the year (TLVB) from what the beneficiary's liability would have been if the trust gains accrued to that beneficiary rather than to the trustees (TLVA). In calculating TLVA, no deduction is made for any allowable capital losses of the trustees.

If the vulnerable beneficiary is not resident in the UK, the component parts of VQTG (i.e. TLVA – TLVB) are calculated on the basis of the beneficiary's "deemed taxable amount", which calculated by reference to the tax on his/her actual gains and losses plus "assumed gains and losses". Assumed gains and losses are those that would have accrued to the beneficiary if he/she had been resident and domiciled in the UK during the tax year (unless non-residence is only temporary), and if he/she had served the requisite notice to give effect to the loss relief under TCGA 1992, s. 16(2A).

Law: FA 2005, s. 24, 30-32, Sch. 1

Guidance: CG35500ff

7.5 Inheritance tax – disabled trusts

7.5.1 Introduction

For the purposes of inheritance tax (IHT), a discretionary trust primarily for the benefit of a disabled beneficiary can qualify as a disabled trust, in which case the disabled beneficiary is treated as having an interest in possession in the trust property. Consequently, provided the trust itself meets the qualifying conditions set out at **7.5.2**, the trust property is treated for IHT purposes as that of the disabled beneficiary. This means that:

- transfers into disabled a disabled person's trust are treated as potentially exempt transfers or, in appropriate circumstances, as exempt transfers under IHTA 1984 s. 11 (reasonable provision for care and maintenance), and
- no tax will arise on any distribution of trust property to the disabled beneficiary, but
- there will be a charge to inheritance tax on the trust property when the disabled beneficiary dies or the trust otherwise ceases to qualify as a disabled person's trust, unless the disabled beneficiary becomes entitled to the trust property absolutely.

This IHT treatment contrasts favourably with that applicable to most discretionary trusts with tax charges on entry and exit and the periodic 10-yearly charge.

Disabled trust treatment can also apply where an individual settles property on himself or herself in anticipation of becoming a disabled person at some time in the future (see **7.5.3**).

The basic qualifying conditions for disabled trusts and the definition of disabled person were aligned with their equivalents in the legislation on vulnerable trusts for income tax and capital gains tax purposes by FA 2013 and FA 2014, when the introduction of the personal independence payment, and other changes in social security, provided the opportunity to review and simplify the tax regime. The IHT rules about trusts for bereaved minors (IHTA 1984, s. 71A) were similarly aligned with the equivalent rules on vulnerable trusts.

Law: IHTA 1984, s. 89-89C

Guidance: IHTM 04102, 42805

7.5.2 Qualifying conditions for a disabled trust

The special tax treatment for IHT purposes applies to trusts in which, during the lifetime of the disabled beneficiary, no interest in possession subsists, and which secure that, if any of the settled property or income arising from it is applied during the disabled person's life for the benefit of a beneficiary, it is applied for the benefit of the disabled person.

If the disabled person does have an interest in possession (even if established post March 2006), the trust property will be treated as belonging to them for IHT purposes in any case. The reason for this is that an interest in possession which is a disabled person's interest is a qualifying interest in possession for IHT, under s 49 IHTA 1984. Extending the same treatment to trusts in which no interest in possession subsists, i.e. discretionary trusts, ensures that the same favourable regime can apply across the board where a disabled person is the principal beneficiary.

"Disabled person" for these purposes is defined in the same way as for the income tax and capital gains tax regime for vulnerable trusts (see **7.2**). Except in cases of self-settlement in anticipation of becoming disabled, for the trust to qualify as a disabled person's trust, the beneficiary must have been disabled at the time the property was put into trust.

As with vulnerable trusts (see **7.3.2**), the condition which requires nothing to be distributed to any beneficiary apart from the disabled person is not breached if:

- the trustees have powers of advancement under the Trustee Act 1925, s. 32 or similar such powers, even without the restriction in s. 32(1)(a) that any such advancement must be limited to the share, or prospective share, in the trust of the recipient of the advance;

- the trustees use that power to apply for the benefit of someone other than the disabled beneficiary amounts up to the annual limit of £3,000 or (if lower) 3% of the maximum value of the trust property in the year (subject to revision by Treasury order).

The annual limit applies for each period of 12 months that begins on 6 April.

Law: IHTA 1984, s. 89, 89B(1)(a), (c)

Guidance: IHTM 42805

7.5.3 Self-settlement by a person who is expected to become disabled

A relief introduced from Budget Day (22 March) 2006 enables a settlor to transfer their own property into trust for themselves if they satisfy HMRC that they have a condition that it is reasonable to expect will lead to their becoming a disabled person (as defined for the purposes of vulnerable trusts – see **7.2**). The effect for IHT purposes is that the settlor is treated as having an interest in possession in the trust property; consequently, the transfer into trust is not chargeable to IHT, nor is any distribution of the trust property (capital or income) back to the settlor.

During the lifetime of the settlor, no settled property may be applied for anyone's benefit but the settlor's, save for the exercise by the trustees of statutory or other similar powers of advancement that enable them to advance up to the lower of £3,000, or 3% of the value of the trust property, to another person (for example, if the settlor wished to make a gift, or pay for a holiday for their carer). If the settlement comes to an end during the settlor's lifetime, either the settlor or another person must become entitled to the trust property absolutely, or another disabled person's trust (see **7.5.2**) must be set up with the trust fund.

In determining whether the settlor is likely to become a disabled person (as defined), it is assumed that:

- they meet any conditions as to residence or presence for them to be entitled to whichever benefit is necessary for them to qualify as a disabled person;
- they will not be disqualified from receiving a benefit because of being an in-patient in hospital, or a person for whom accommodation is provided for certain health reasons, or in prison.

As with vulnerable trusts (see **7.3.2**) and disabled trusts generally (see **7.5.2**), the condition which requires nothing to be distributed to anyone other than the settlor is not breached if:

- the trustees have powers of advancement under the Trustee Act 1925, s. 32 or similar such powers, even without the restriction in s. 32(1)(a) that any such advancement must be limited to the share, or prospective share, in the trust of the recipient of the advance;
- the trustees use that power to apply for the benefit of someone other than the settlor amounts up to the annual limit of £3,000 or (if lower) 3% of the maximum value of the trust property in the year (subject to revision by Treasury order).

The annual limit applies for each period of 12 months that begins on 6 April.

Law: IHTA 1984, s. 89A, 89B(1)(b), (d)

Guidance: IHTM 42805

7.5.4 Interaction between inheritance tax and capital gains tax – an overview

When a disabled person entitled to a life interest in a disabled trust (see **7.5.2**) dies, the trust assets in which the life interest subsists are deemed to be disposed of by the trustees and immediately reacquired by them at their market value, but no chargeable gain arises on the disposal. This CGT-free uplift has always been a feature of disabled trusts in which the beneficiary had an actual interest in possession, but for deaths on or after 5 December 2013 is extended to discretionary trusts that qualify as a disabled person's trust for IHT purposes. That corrected the previous position where the trustees could become liable to a double charge to tax – to IHT on the death of the disabled beneficiary who was deemed for the purposes of that tax to have an interest in possession, and to CGT because the tax-free uplift did not previously apply where the interest in possession was not an actual one.

Because a transfer of assets to a disabled person's trust is treated for IHT as a potentially exempt transfer (PET), CGT hold-over relief under s. 260 TCGA 1992 is not available on such a transaction. Thus, an IHT liability may still arise, even though CGT has been paid, if the settlor dies within seven years of the transfer.

However, if qualifying business assets are gifted to a disabled person's trust, business asset hold-over relief may be claimed to defer the gain, under s. 165 TCGA 1992, even if the settlor retains an interest in the settled property (see **7.5.3**).

Law: TCGA 1992, s. 72, 73, 165, 169D, 260