Tax Overview Protective Property Trust

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Tax Overview
Protective Property Trust

This guide is to help you understand the key points of how Protective Property Trusts are taxed and is based on the current 2023/2024 tax year rules and therefore could be subject to change.

This guide applies to married couples and civil partners (C.P). In brief, the Protective Property Trust begins on the death of the first spouse/C.P. and provides the survivor with a 'life interest' to continue residing in the property and receive any income that may arise from this. The survivor is also known as the 'life tenant'.

The specific terms of the trust are in the will. The trust ends on the death of the life tenant and is when the trustees transfer the trust property to the beneficiaries.

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Inheritance Tax (IHT)

- Married couples / C.P. benefit from the spousal exemption.
- This type of trust qualifies for the Residence Nil Rate Band (subject to qualifying criteria) and may be claimed by the executors on second death. Typically, this is where the gross value of the estate is less than £2million and the beneficiaries are children, step-children, or grandchildren.
- There are no entry, anniversary or exit charges apply to this type of trust.
- The value of the trust fund is combined with the personal estate of the life tenant.
- On death of the life tenant, IHT may be due if the value exceeds available allowances and reliefs. If IHT is due, the trust will pay a proportionate share of this from trust funds.
- If the survivor (known as the 'life tenant') ends the trust early, this will be viewed as a gift ('Potentially Exempt Transfer'). If he/she survives seven years, then no tax is due.
- If he/she dies within seven years of ending the trust early, then whether Inheritance Tax needs to be paid on the Potentially Exempt Transfer will depend on the availability of the Nil Rate Band.

Capital Gains Tax (CGT)

- There is no Capital Gains Tax (CGT) payable on death of the first spouse / C.P.
- The trustees will receive the property at market value (Probate value) at time of death.

- If the property in trust was the main residence of the couple, then private residence relief will be available in most cases and mean no CGT is payable if the property is sold e.g. if the life tenant wants to move or downsize.
- On death of the life tenant, the value of the trust property is given a further tax-free uplift to market value (Probate value).
- When the trustees transfer the property to the beneficiaries, CGT will only be payable if the property has risen in value above the Probate value.
- From 06.04.23, trustees have an annual exempt allowance of £3000. This reduces to £1500 from 06.04.24.
- The CGT rate for trustees is 20% and 28% for residential property.

Income Tax

- Income is not usually generated by this type of trust unless the life tenant has moved out of the property and this is rented out or surplus from downsizing has been invested to produce an income.
- The trustees may mandate income to be paid directly to the life tenant so that they declare and pay any tax arising rather than the trust. The advantage of this is that the life tenant may use his/her personal allowances.
- If the trustees instead pay the income tax, this will be at 8.75% on dividends and 20% on other forms of income. Trustees do not have any savings or dividends allowances.

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How it works in practice

John and Mary include a Protective Property Trust in their Wills. The trustees and beneficiaries are their two children, Clive and Linda.

John dies first. The terms of the trust give Mary the right to live in the property for life and any income that may arise. No income will arise if Mary lives in the property until her death. If Mary moves house and downsizes, surplus cash is divided between John's trust and Mary. If the house is sold for £500,000, and Mary buys a new home for £250,000, there will be £250,000 left after the sale. Mary will get £125,000 for herself, and John's trust will hold the other £125,000. The trustees should seek financial advice and invest John's share of the proceeds. Mary will receive the income (i.e. interest or dividends) for the rest of her life, however, John's share of the property and proceeds from downsizing remain protected. When Mary dies, the trust ends and Clive and Linda inherit any property or money held by John's trust.

Income Tax

If there is income from downsizing, this will usually be paid directly to Mary so she can deal with this via her tax return.

If Mary does not downsize but moves into residential care, the trustees may decide to rent out her property. The trustees will pay income tax according to the applicable rates and Mary will receive the net proceeds. If Mary is a non-taxpayer, she can utilise personal allowances to reclaim the tax paid.

Inheritance Tax

As John and Mary are married, there is no inheritance tax charge on John's death when the property enters the trust due to the spouse exemption. John and Mary made no taxable gifts in the seven years before their deaths, so they each have a full Nil Rate Band allowance available. On Mary's death, her executors can claim John's unused Nil Rate Band (£325,000) and his share of the Residence Nil Rate Band (£175,000) to combine with her allowances (£325,000 Nil Rate Band and Residence Nil Rate Band £175,000). If Mary's estate is worth less than £1 million, there will be no inheritance tax to pay.

If Mary had decided to end the trust early, or if the trust stated that it would end on an event earlier than Mary's death (e.g. remarriage or moving out of her home), the property is considered a gift by Mary and classed as a potentially exempt transfer. If she survives seven years from the date of the trust ending, the gift drops out of Mary's taxable estate and won't use up any of Mary's available Nil Rate Band. If she dies within seven years, her available Nil Rate Band allowance is reduced by the value of John's trust fund.

Capital Gains Tax

The property is John and Mary's home and meets the private residence relief requirements. On John's death, the property will be given a tax-free uplift to the value at the date of John's death. This will happen again if Mary still has the house when she dies. If Mary has moved into residential care, her executors can claim private residence relief for 36 months whilst she is not occupying the property. The trustees will transfer the property to Clive and Linda upon Mary's death. If Clive and Linda sell the house, they can utilise their available personal allowances on any increase in value between Mary's death and the sale.

Trust Registration

If the trust still exists two years after death, the trustees must register the trust with HMRC within 90 days. The exception is that if the trust incurs a UK tax liability earlier than the two-year anniversary, it must be registered within 90 days of the tax liability arising.

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