A Brief Guide to……… Trusts

Trusts have for many years been used as a key tool in tax planning, and have many uses and potential advantages, both for tax and other purposes.

Key terms:

Settlor — The settlor is the person establishing the trust, usually by transferring an asset from their ownership to the trust. Whilst more than one settlor can contribute property to a single trust, this can cause complications under certain circumstances.

Trustee — The trustee is the person tasked with administering the trust, in accordance with the directions set out in the trust deed. It is usually best practice to have more than one trustee, and it is common for professionals (e.g. a solicitor or accountant) to be appointed to act alongside family members.

Beneficiary — The beneficiary is the person who benefits from the trust. The extent of their beneficial interest will depend upon the type of trust, and any directions given within the trust deed.

Whilst the same person can act in each of the above capacities, it is usually best to avoid the Settlor also being a Beneficiary, as this can nullify certain taxation planning opportunities.

Types of trust:

Whilst there are a variety of trusts, the most common that are in use for tax planning purposes are as follows:

Discretionary Trust — A discretionary trust will usually give the trustees the discretion to determining how the trust capital (i.e. the amounts put into the trust initially) and any income or benefit arising subsequently should be dealt with. This type of trust is very flexible, and the settlor has a great deal of choice in how much discretion they give the trustees.

Life Interest Trust — A life interest trust (also known as an interest in possession trust) gives the beneficiary a right to the income or benefit arising on the trust's capital. Any entitlement to the trust's capital will be separately specified in the trust deed.

Why use a trust?

Some of the most common reasons for using a trust are:

<u>Inheritance Tax Planning</u>

Establishing a lifetime trust can help to reduce the value of your estate, and therefore the inheritance tax payable upon your death. For estates exceeding the Nil Rate Band (currently £325,000), inheritance tax can be payable at 40%. With the Nil Rate Band having been frozen for several years now, and property values having increased significantly in the same period, more and more people are likely to find that the taxman will want to take a slice of any assets that they leave to their children.

Protection of assets

You may wish to pass on some of your wealth to future generations, but retain a degree of control over the asset. This might be the case if the beneficiaries are not capable of holding the asset responsibly (for example if they are a minor, disabled or likely to fritter it away). Alternatively, you may have concerns that the asset might be in jeopardy in the event of a divorce, death or bankruptcy, or that it might affect entitlement to certain state benefits. Establishing a trust enables the trustees to retain control of the asset, whilst enabling the beneficiary to enjoy the use of the asset, and/or the income arising.

Capital Gains Tax benefits

The gift of an asset from one person to another will usually be a chargeable disposal for capital gains tax purposes. This can prove to be a significant disadvantage in making lifetime gifts, unless there is no capital gain arising (e.g. if you are simply making a cash gift). Using a trust enables both the settlor and the beneficiary to take advantage of Capital Gains Tax Holdover reliefs which are available on both a gift to a trust, and the transfer out from a trust to a beneficiary. These reliefs have the effect of deferring the capital gain until the asset is ultimately disposed of by the beneficiary.

Income Tax benefits

Making a gift from your income will usually mean that this income has suffered income tax in your hands, as donor, before it passes to the donee. If you are a higher or additional rate taxpayer, this will mean that the taxman takes a significant slice of this income, reducing the amount that you can then pass on. If instead, an income-producing asset is placed in trust, when the income is distributed to the beneficiary from the trust, they will effectively be taxed on this income at their marginal tax rate, rather than the settlor's potentially higher tax rate. This is a common planning tool for higher rate taxpayers wishing to make provision for grandchildren's school fees and similar.

How do I set up a trust, and how is it operated?

Trust deed

Firstly, a trust is usually established by a deed drawn up by a solicitor or other legal professional. The deed will set out how the trust will be operated, who the settlor, trustees and beneficiaries are, and any specific directions that the settlor wants the trustees to follow.

Income Tax

Trusts also need to be registered with H M Revenue & Customs, who will issue an annual tax return to the trustees if there will be income and/or capital gains to declare. The trustees will need to calculate the tax due, and pay this from the trust funds. The rate of tax that the trust pays will depend on whether it is discretionary or not, as shown below:

	Dividends	Other income
Discretionary	38.1%	45%
Non-discretionary	7.5%	20%

Discretionary trusts do also benefit from a 'standard rate band' of £1,000. Income up to this level is taxed at the basic rate (i.e. 7.5% for dividends or 20% for other income).

When a trust beneficiary receives income from the trust, they then receive a credit for the tax already suffered by the trust. This means that the beneficiary will often be able to reclaim all or part of the tax that the trust has suffered from HMRC.

Accounting for the trust assets

The trustees may want to consider the preparation of trust accounts, as these can help keep track of the trust's income and capital, as well as reconciling the trust assets.

Inheritance Tax

Trusts are chargeable to inheritance tax in their own right, and a return must be made to HMRC on each 10 year anniversary of the trust, and also when capital leaves the trust. The maximum rate of the inheritance charge on trusts is 6%, and as trusts also have their own Nil Rate Band, many trusts will have a lower tax rate, or no tax to pay at all.

Other considerations

Settlor retaining benefit

Under most circumstances it is not advisable for the settlor to be able to benefit from the trust. This will usually result in the trust being ineffective for inheritance tax purposes.
There are also rules in place where a spouse, civil partner or minor children can benefit from a trust, effectively meaning that the trust income is taxable on the settlor at their marginal income tax rate.

Choosing the trustees

It is usually advisable to have at least two trustees in place. If a sole trustee is in place, then it is possible for the trust to cease prematurely in the event of their death.
It can also be useful to have an independent trustee (for example an accountant or solicitor) to provide an element of balance in the event of any disagreement between the other trustees, or in case there may be some family disagreement in the future.

Find out more

For further information, advice and guidance please contact one of our specialists:

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This is a general illustrative guide only, and individual professional advice should be obtained on specific issues. The information is believed to be correct at the time of publication, but may alter.

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