AJ Bell Investcentre

ADVISER GUIDE

INTRODUCTION TO TRUSTS

Introduction to trusts

The information contained in this guide is based on our understanding of current law, practice and taxation which may be subject to change.

What is a trust?

A trust is the formal transfer of assets to a small group of people (or trust company) with instructions that they hold the assets for the benefit of others. There are different types of trusts and they are taxed differently.

If a trust is to be made in someone's lifetime, to take immediate effect, then it is usually evidenced by a trust deed. If it is to be created on or shortly after death, then the trust provisions will be set out via a will.

The trust deed states what comprises the trust property (the assets within the trust), who will be responsible for looking after the gifted assets (the trustees), who is to benefit (the beneficiaries), and any rules or conditions to which these trustees and beneficiaries must adhere.

At the point the assets are transferred, legal ownership of the assets will transfer from the person making the trust (the settlor) to the trustees.

However, the trustees have an obligation to deal with the property for the benefit of beneficiaries. These beneficiaries will have what is known as 'beneficial ownership' of the assets. This means that only they – and not the trustees themselves – can benefit from the property in the trust.

So, wherever there is a separation of legal ownership (title) and beneficial ownership, a trust arrangement will exist.

This is why this arrangement is called a 'trust' – i.e. the trustees are in a position of trust and have a duty, among other things, to protect and secure the trust property, and to use the assets of the trust as instructed by the trust deed.

Why set up a trust?

Trusts are set up for a number of reasons, including:

- to control and protect family assets;
- when someone is too young to handle their affairs;
- when someone cannot handle their affairs because of incapacitation;
- to pass on assets whilst alive;
- to pass on assets on death (a 'will trust'); and
- under the rules of inheritance if someone dies without a will (in England and Wales).

Control

If an individual made an outright gift to someone, the new owner assumes all rights (legal and beneficial) over the asset and can do what they want with it. The person making the gift has given away all control.

By creating a trust, the same individual could still make a gift (as a settlor) but can attach certain conditions to it. They can give away their asset, but 'with strings attached'.

The person establishing a trust can set out in the trust document how the asset(s) is to be dealt with. They can state who will benefit and to what extent; whether the property may be sold or used for certain purposes; and who will benefit from it in the future.

The day-to-day management of the trust property is the responsibility of the trustees, but if the settlor is alive, they could also be a trustee. They could therefore be involved with managing property that they no longer own – provided their decisions are made in the interests of the beneficiaries and in accordance with the terms of the trust.

Protection of family wealth

Like making a lifetime outright gift, a gift can be made to a trust to protect assets from tax, namely Inheritance Tax (IHT). We will talk about how gifts into different types of trust are treated for tax shortly.

Using a trust can restrict the amount and type of benefit received from the wealth/property.

Trusts are particularly relevant where the intended beneficiary of the gift is too young to be able to manage and control the property. By gifting the assets in the first instance to a trust, the settlor can retain some degree of control over the assets and how they are used to benefit the beneficiaries.

Flexibility

A trust can allow the trustees to adapt to circumstances as they arise. Contrast this with an outright gift where you cannot change your mind further down the line and give the asset to someone else.

The who

Whether the trust is a lifetime settlement or set up by a will, the trust document or deed will state:

- what is included in the trust fund (the initial trust property);
- who is responsible for looking after the gifted assets (the trustees);
- who will benefit (the beneficiaries); and
- any rules or conditions the trustees and beneficiaries must adhere to.

Settlor

The settlor is the person who makes the settlement and who transfers the assets to the trustees.

Sometimes the settlor can also benefit from the assets in a trust – this is called a 'settlor-interested' trust and has special tax rules and anti-avoidance measures.

Trustees

On creation of the trust, legal ownership will pass from the settlor to the trustees. Trustees, like a company or an individual, are a separate legal person. As such, they have Income Tax, Capital Gains Tax (CGT) and IHT liabilities.

Generally speaking, any person may act as a trustee as long as they are mentally capable of doing so. The settlor will specify in the trust deed who shall be the trustees of the trust. Most trusts have a minimum of two trustees. There is no legal obstacle to a settlor appointing themselves as a trustee. Indeed, in many family trusts, the settlor will act as a trustee possibly alongside a professional such as a family solicitor. This gives the settlor power to have some say in how the income and capital of the trust should be distributed.

If the trustees change, the trust can continue, but there always has to be at least one trustee.

The trustees will deal with the assets according to the settlor's wishes (as set out in the trust deed or their will), manage the trust on a day-to-day basis and pay any tax due.

Becoming a trustee imposes a duty of undivided loyalty and good faith towards the beneficiaries. The trustees are, therefore, required to suppress their own interests and fulfil their obligations with the beneficiaries' best interests at heart.

Specifically, a trustee should undertake:

- to always act in accordance with the trust deed (or will);
- not to profit from their trustee position;
- to avoid conflicts of interest between their interests and the interests of the beneficiaries; and
- to properly invest trust property.

Keeping proper records is essential. These records will include trust income and expenses, and tax pool records if necessary. The records will help the trustees to complete tax returns and pass the correct and necessary information to beneficiaries.

The legal responsibility for registration, where appropriate, with the Trust Registration Service, lies with the trustees.

Beneficiaries

Within the deed, the settlor will nominate the person or persons who shall be the beneficiaries of the trust.

There might be more than one beneficiary, like a whole family or defined group of people. They may benefit from:

- the income of a trust only, for example from renting out a house held in a trust;
- the capital only, for example getting shares held in a trust when they reach a certain age; or
- both the income and capital of the trust.

Trustee investment powers

Trustee Act 2000 (England and Wales)
Charities and Trustee Investment (Scotland) Act 2005
Trustee Act (Northern Ireland) 2001

These three acts grant wide investment powers (especially when compared with past legislation), meaning that trustees can invest in any type of asset.

Although most modern trusts might refer to investments allowed by the Trustee Acts, it is still possible that the trust deed might include some restrictions, so clearly it is important to know and understand what powers have been granted.

In England and Wales, the Trustee Act 2000 introduced a statutory duty of care for trustees. This includes a duty to apply the 'standard investment criteria' and a duty to obtain proper advice when making or reviewing investments.

The standard investment criteria include an assessment of the suitability to the trust of the investments and the need for diversification as appropriate.

In terms of investment advice, trustees have a duty to seek 'proper' advice unless they can conclude that it is unnecessary or uneconomical to do so. Many trustees will have to take investment advice unless they have the necessary knowledge and experience themselves.

If the trustees engage an investment manager (discretionary fund manager), they must provide an investment policy statement.

Other considerations when making investments will be similar to those considered for individual clients, along with a focus on what future payments might be required for beneficiaries and when, as well as some of the taxation aspects we will cover in the next section.

Types of trust

This guide assumes the trust is treated as UK resident for Income Tax and CGT. This means they will be taxable on their worldwide income and gains.

Changes brought in via the Relevant Property Regime in 2006 generally mean that a trust will either be 'discretionary' or 'non-discretionary'.

Discretionary

These are the most flexible forms of trust. However, this flexibility and the potential for control comes at a price in terms of the tax treatment.

From the settlor's point of view, a wide range of beneficiaries can be named, as well as classes of beneficiaries.

Under a discretionary trust, the beneficiaries have no automatic right to receive any of the trust income or capital and have no legal entitlements under the terms of the trust. The clue is in the name – the trustees have complete discretion as to the distribution of income and/or capital. When income is received by the trustees from the assets held within the trust, the trustees can decide whether to accumulate all or some and, if they choose to distribute, how much and to whom.

We talked about protecting family wealth in the first section and discretionary trusts are a popular way of achieving this objective for future generations. The trust property will not be included in the assets of the beneficiaries on divorce, bankruptcy or death.

Tax – discretionary trust

IHT

Gifts into a discretionary trust will be chargeable lifetime transfers (CLTs).

If the value of the gift (plus any other CLTs made in the previous seven years) is over the nil rate band for each settlor, then IHT will be charged on the excess, at the lifetime rate of 20%. Annual exempt amounts from the current and previous years are also available to cover up to £6,000 per settlor.

Additional IHT may be payable if the settlor dies within seven years of creating the trust.

The trust itself will be assessed to IHT every 10 years, known as the 'periodic' charge, and exit charges could apply when capital is paid from the trust.

For a periodic charge, the value of the trust less the nil rate band available to the trust will be calculated and any excess amount will be subject to tax at 6%. So, if the value of the trust is less than the nil rate band, no charge will apply.

An IHT 'exit charge' is calculated when capital is distributed to a beneficiary.

Generally, if no lifetime tax was due on creation of the trust, there's not normally any IHT due on any distributions made in the first 10 years.

For discretionary will trusts, there will be no IHT exit charge where distributions are made within two years of the settlor's death. Other special rules also apply for will trusts and distributions made within two years of death.

These charges can be very complex, and we would strongly suggest that these are undertaken by or with the assistance of an accountant or solicitor.

CGT

Transferring existing unit trusts or OEICs into a discretionary trust could trigger a CGT charge, although holdover relief may be available. Assigning investment bonds or cash gifts into a trust will not count as disposals.

Assets transferred to a trust on the settlor's death won't normally have been subject to CGT. The trustees are treated as acquiring the assets at their market value at the date of death.

When trust assets are sold, the process for calculating gains is the same as for individuals, but any tax will be payable at trust rates of CGT (20%, or 24% for residential property).

The trustees are only entitled to half the individual annual CGT exempt amount (so £1,500 for the current tax year), although this could be even smaller if the settlor has created multiple trusts.

If the trustees made a payment of capital to a beneficiary by transferring assets, then this will also be a CGT disposal. There is another chance to use holdover relief if the trustee and beneficiary elect to do so and this will postpone the gain until the beneficiary sells the asset.

Income Tax

Income from a unit trust or OEIC held in a discretionary trust will be taxable upon the trustees, as will property rental income and interest.

	Dividends	Other income
First £1,000	8.75%	20%
Above £1,000	39.35%	45%

The first £1,000 standard rate band is used by non-savings income first, then savings income, followed by dividends as per the standard rules for Income Tax. All income over this band is taxed at the 'trust' rates above.

If the settlor has created more than one settlement, the £1,000 will be split equally between each, subject to a minimum of £200 per trust.

No dividend and personal savings allowances are available to trustees.

Beneficiary

Trust income distributed to discretionary trust beneficiaries is payable with a 45% Income Tax credit in all cases, i.e. it is deemed to be trust income, regardless of its actual source.

The 45% tax credit means that the beneficiary could claim some or all of the tax back if they are a non-taxpayer or pay tax at 20% or 40% (rest of UK rates – different rates apply to Scottish taxpayers).

Gross income distributed	£5,000
Beneficiary receives	£2,750
Tax credit (45%)	£2,250
Non-taxpayer can reclaim £2,250; basic rate taxpayer £1,250	

The beneficiary will receive an R185 form from the trustees which will show the credit and help them ascertain whether they are able to reclaim all or some of the tax based on their own marginal rate.

The tax pool is a record of the tax actually paid by the trustees of a discretionary trust on income they receive. All Income Tax can enter the tax pool, apart from tax paid by trustees on income used to meet trust management expenses.

Under the Income Tax rules for discretionary trusts, the trustees will pay Income Tax at various rates depending on the source and availability of the standard rate band for trusts. If the income is from a mix of sources, then a combination of these rates will be applied. The tax pool then increases by the amount of tax paid.

The pool is a crucial tool for trustees to check that they have actually paid enough Income Tax on the income received to support the 45% credit due to beneficiaries when a distribution is paid.

If the 45% tax credit exceeds the actual tax paid by the trustees in the year, then the deficit needs to be made good. The trustees can do this by using an existing balance in the tax pool from Income Tax paid in other years or, in the absence of this, the trustees must make up the difference through the Trust and Estates tax return if they have already made a payment.

Investment bonds

There is no Income Tax charge unless a chargeable event occurs. This is because investment bonds are not deemed to produce an income.

When a chargeable event occurs on a bond owned by trustees, any gain will be assessed to Income Tax on the settlor if they are alive and UK resident, in the same way as if they owned it as an individual, so top-slicing relief will be available.

If the settlor is not alive (and it is not the year of their death), the trustees will be liable. If the trustees were looking to make a capital distribution, they could assign segments to a beneficiary. The gains on surrenders would then be assessed on that beneficiary personally.

Interest in possession trusts

You might hear these referred to as life interest trusts.

The trustees have no power to accumulate the income within the trust. Under the terms, the trustees must pay out the income of the trust to the named beneficiary/ies.

The income beneficiary is called the 'life tenant' or the life renter. In a typical interest in possession trust, the life tenant will be entitled to income for life (or a specific age or point in time). Then the capital of the trust will pass to another beneficiary called a 'remainderman' or reversionary beneficiary.

When making investments, the trustees have responsibilities to both the life tenant and the beneficiaries entitled to capital and should take account of the interests of both when choosing where to invest, unless the trust deed says otherwise.

These trusts may be created during lifetime or on death and are quite common in wills. They can also be created under the law of intestacy or a deed of variation where you may see them referred to as an immediate post-death interest or IPDI.

Since 22 March 2006, new interest in possession trusts are now subject to the same IHT regime as discretionary trusts and their use has declined.

Taxation – interest in possession (IIP)

IHT

The IHT treatment of an IIP trust depends on whether it is created during lifetime or on death. For lifetime trusts, the main issue is whether the trust was created before or after 22 March 2006.

Like in a discretionary trust, lifetime gifts are chargeable lifetime transfers (CLTs) that are subject to IHT at 20% if they exceed the settlor's nil rate band. Before 22 March 2006, the transfer would have been a potentially exempt transfer (PET).

IIP trusts set up after 22 March 2006 do not fall into the taxable estate of any beneficiary but periodic and exit charges could apply.

There will be a chargeable transfer (by the deceased) for a trust set up on death unless the spousal/civil partner exemption applies.

IIP trusts created on death or before 22 March 2006 are not treated as 'relevant property' and so the trust will not be subject to periodic or exit charges. Instead, the value of the trust will form part of the life tenant's taxable estate on their death.

CGT

The CGT treatment of IIP trusts is the same as discretionary trusts. Again, holdover relief may be available.

If the trustees made a payment of capital to a beneficiary by transferring assets, then this will also be a CGT disposal. There is another chance to use holdover relief if the trustee and beneficiary elect to do so and this will postpone the gain until the beneficiary sells the asset.

Income Tax

The trustees are not able to accumulate income and all income must be paid to the named beneficiary. There are two ways trustees can do this.

1. The trustees can account for and pay tax at basic rate on income received at 8.75% for dividends and 20% for all other income. This option allows the trustees to deduct relevant expenses but means they will have to complete a tax return for the trust. Non-taxpayer beneficiaries can reclaim overpaid tax.
2. The trustees can 'mandate' the income directly to the beneficiary. All the tax is then directly assessable by the beneficiary as if it were their own. This is the simpler option, but no trustee expenses can be deducted.

As there are named income beneficiaries, a trust created by a parent for their minor child will be caught by the parental settlement rules.

Bare trusts

Bare trusts are the simplest form of trust.

The named beneficiary/ies are fixed and named at outset and cannot be changed. So, although future children or grandchildren can't be added once the trust is set up, new settlements could be created for their benefit.

A bare trust could be established and run by a grandparent as one of the trustees.

A gift made to establish a bare trust will be a potentially exempt transfer (PETs) so, although there is no 'limit' to what can be paid in, there are IHT considerations to be aware of.

The beneficiary has a right (an absolute entitlement) to the trust capital and any income generated from it.

This means the child's own Income Tax allowances and CGT allowances can be used. Income and gains could therefore be tax free if these allowances are not exceeded.

However, the parental settlement rules will apply if a bare trust is created by a parent. If income generated is in excess of £100 a year, then the whole amount will be treated as the parent's own for tax purposes.

Access

Provided the trust property is used for the benefit of the beneficiary, income and capital can be withdrawn from the account at the instruction of the trustees before the beneficiary reaches age 18 (16 in Scotland).

The trust can continue once the beneficiary reaches majority.

However, the trustees will need to notify the beneficiary and pass on details of income and gains generated so that the beneficiary can ensure they are declared and paid as appropriate.

The beneficiary may decide at that point that they do wish to access the capital. If they do demand it, the trustees must pay it to them.

As the beneficiary is treated as if they have owned the investments in the trust since inception, there will be no disposal for CGT purposes at this time. The beneficiary acquires the original base cost of the investments.

Trusts for vulnerable beneficiaries

Trusts are a useful vehicle to protect the interests of vulnerable beneficiaries and special tax treatment exists for certain trusts which are created for a disabled person or a bereaved minor, provided certain conditions are met over who can benefit.

A disabled trust may be created through the will of someone wishing to benefit a disabled or vulnerable friend or relative. Alternatively, the disabled trust could be created by a lifetime gift of cash or assets.

The rules are complex though and the settlor will need to decide whether the potential tax benefits are worth the added complexity and restrictions on who can benefit. They might decide that a normal discretionary trust could achieve the same objectives whilst providing greater flexibility, particularly if tax is not an issue.

Gifts to qualifying trusts are potentially exempt transfers and the trust is not subject to IHT periodic and exit charges.

The trustees can elect to have the trust income and gains taxed at the vulnerable beneficiary's own rates and, if the trust meets the criteria, it will benefit from the full CGT annual exemption.

Personal injury trusts

A personal injury trust is a trust created by an individual who has been awarded a compensation payment following a personal injury. A trust is required if the claimant is a minor or mentally incapable unless a deputy has been appointed to look after their affairs. The individual must be a beneficiary of the trust.

A personal injury trust may be set up as an absolute, interest in possession or discretionary trust – the tax treatment will therefore depend on the type of trust used. They don't offer any special tax planning opportunities unless they also qualify as disabled trusts.

As the injured person is deemed to be the settlor of the trust, the trust will be settlor-interested for Income Tax and CGT and the fund will form part of their estate for IHT.

Trusts are usually set up to prevent the award causing a loss of means-tested benefits, as well as protection of the beneficiary themselves and the opportunity to use a professional trustee.