Trusts

What are Trusts?

Trusts enable assets to be given away whilst still retaining some control over them. Income can be paid to different persons with the capital ultimately going to other persons. Trust may have useful taxation and other features.

Trusts, sometimes called settlements, have been part of the legal and tax system for many years and much case law and tax legislation has been formulated over the years. The reasons for using trusts are as valid today as they have always been.

How are trusts operated?

Trusts are administered by between one and four trustees who are initially selected by the person creating the trust (the 'donor' 'settlor' or grantor'). Trustees can be other relatives, friends professionals or, sometimes, the person who created the trust. As trustees will have considerable powers and freedom to act, trustees must be people you can trust. Professional trustees can be paid for their time but parents are often wary about how much these fees will deplete the trust fund. The trust can meet other trustees' expenses.

Types of Trusts

The basic types of trust are: -

- life interest trust
- discretionary trust
- A discretionary trust with special tax privileges (an accumulation and maintenance trust) can also be established for children and grandchildren.

Life Interest Trust

A life interest trust has the following features. A nominated beneficiary has an interest in the income from the assets in the trust. This right may be for life or some shorter period (perhaps to a certain age). The capital will usually pass onto another beneficiary or beneficiaries. A typical example is where the widow is left the income for life and on her death the capital passes to the children.

Discretionary Trusts

A discretionary trust is so called because no beneficiary has a fixed entitlement and the trustees have complete discretion to decide what, if any, benefits should be allocated to the beneficiaries. The trustees can distribute income and/or capital among a defined class of possible beneficiaries, including the surviving spouse, any children and grandchildren and such other beneficiaries as may even conceivably be intended to benefit. Mere inclusion in the class does not confer any legal right to receive any benefit, and it is entirely up to the trustees to decide how the Trust assets should be used.

In general, the discretionary trust is usually designed to carry on the wishes of the donor. However, since the donor may not be alive when the trust becomes effective, the donor gives the trustee either full or limited discretion to manage the trust assets. The donor may be very explicit in defining the limits of authority for the trustee, or may give such broad powers that the trustee may do anything that the donor would be able to do if the donor were still alive.

The trustee can be the donor initially. In that case, the trust can be either revocable or irrevocable. The trustees can also be a son, daughter, or other relative. It can also be a trust department at a bank or an independent trust company.

Why would anyone create a discretionary trust? The answer is usually because the beneficiary has some special needs. Some of these special needs are:

- Children or other relatives may have a physical or mental handicap. This circumstance is explored in detail below.
- Elderly parents may be in the same position as the handicapped child described above. A similar trust can be established for their benefit. Or the trust can provide for the full long term care that a parent requires.
- Often the concern is what to do about a spendthrift child. You may realize that it would not be a good idea to bestow a large amount of money on such a beneficiary. It could also be that the child has a problem with alcohol, or other substances. It may be that creditors are constantly coming after them. A discretionary trust may be your answer.
- Another application for the discretionary trust is for children who have been very successful and do not need to add to their own estate from yours. It has been said, "Which is better, to have the money, or to have the use of the money?" It is possible to set up a discretionary trust which can buy and manage assets for your wealthy children, and even your grandchildren. It could own a summer home, a boat, or any other asset that could be used by your children. It can also lend to them money to acquire such assets, or pay for educations, and get paid back the loan over time.

A Discretionary Trust needs to be properly administered. This involves the trustees filing annual tax returns and issuing appropriate tax deduction certificates to beneficiaries who have received income. The trustees should also maintain Trust accounts and properly manage the Trust's property or investments. The amount of administrative work will depend on the nature of the Trust assets and on the frequency or otherwise of distributions of income and capital.

Discretionary Trusts for People with Special Needs

Discretionary trusts are set up by parents or other relatives as a way of making long term financial provision for a disabled child. The reason a trust is useful is that assets once put in trust do not belong to the donor, (parents) or the "object" of the trust (disabled son or daughter who is intended to benefit). This means that the capital held in the trust is not taken into account when assessing entitlement to state benefits like Income Support or local authority obligations to fund care.

If parents leave a will which says words like "our son hereby inherits our worldly goods" and the goods amount to more than about £3,000 the effect will be to immediately take their son or daughter out of some Social Security means tested benefits. Local authority (Social Services) support may also cease until the value of the inheritance falls below a threshold level. In addition if the disabled son or daughter is unable to manage money then the Court of Protection can get involved. They will appoint a person called a "receiver" to look after the money and other assets. The receiver may not be the person the disabled person or parents would choose.

Trusts are used to pay for extra things which Social Security benefits may not fund, a holiday, new clothes, electrical goods, special equipment. Importantly a trust can also hold, manage and maintain the parental home if put into the trust.

It is also worth bearing in mind that not to make any provision at all for a disabled son or daughter on the grounds that another member of the family will look after them or that the state will provide may not be a wise course. This is because under the Inheritance Act (1975) if insufficient provision is made it is possible for Social Services and the Department of Social Security to challenge the will. In turn this can result in an unpleasant, unhelpful and costly legal dispute.

Property held in trust

There are several advantages of holding property in a trust:

- trustees can deal with all the management and maintenance of the property thus if the disabled person is unable to organise this or do it themselves or lacks legal capacity the problem of how to arrange maintenance can be solved
- if in addition money is put into trust over and above the property this can provide a fund to pay for repairs or upgrading the property

The trustees do not necessarily have to do all the maintenance themselves; they could contract with a local housing association or private agency for this service. Note that the trust is not a legal entity so contracts are between the trustees collectively and the other organisation.

The question is sometimes asked as to whether a trust can rent a property to a beneficiary, on the basis that the beneficiary will claim Housing Benefit that will meet the rent charge. This matter is covered by statutory instrument no. 3257 (the Housing Benefit (General) Amendment (No.2) Regulations 1998 - this says that Housing Benefit is not payable in certain circumstances, which includes a person who is a beneficiary of a trust. However, where the Housing Benefit administrators are satisfied that the "liability was not intended to be a means of taking advantage of the Housing Benefit scheme", and then Housing Benefit payment may be made to an eligible claimant. However, it must not be assumed that a person will automatically receive Housing Benefit. It is a matter of discretion within the Housing Benefit department.

GENERAL PROTECTION TRUSTS (GPT)

- Residential Care Fees. For spouses or civil partners after the first death if the survivor needs residential health care then potentially almost all of the survivors' wealth could be used up paying for it. A PPT can ensure that whatever is placed in the trust on first death is protected.
- If all your assets, including life insurances & any pension fund payouts at the time of your death, add up to more than about £325,000 you may be liable for Inheritance Tax. Spouses/civil partners can 'pass on' un-used Nil Rate Band to their spouses/civil partners on their death. Only one GPT can be passed on in this way. So widows/widowers who re-marry can't pass on the up to two GPT's they may have the use of on their death. In these & other circumstances PPT's can save IHT.
- A PPT can also give IHT savings if the assets transferred into the trust are expected to grow in value at a faster rate than the anticipated future increase in the GPT. A house & land will often fall into this category!
- Keeping Assets 'Safe for the Children'. After first death the survivor can benefit from assets held in the PPT but whatever happens to the survivor, e.g., re-marriage or bankruptcy, the assets in the PPT are protected. If, for example children, should ever suffer divorce the former spouse cannot claim any assets that are held in a PPT.
- Keeping Control of Assets Out of 'Unsuitable' Hands. A PPT can keep assets safe from, e.g., children who would fritter the money away, whilst still allowing those children to benefit from the assets in a controlled way.
- Unmarried Partners. A PPT can make the most of the Inheritance Tax (IHT) allowances available to unmarried partners & minimise IHT payable on second death.
- Business & Agricultural Assets. Reliefs are available for business & agricultural assets that eliminate or substantially reduce IHT. Using a PPT can preserve that benefit so that it is not lost to people who in later life might sell their business or agricultural assets before death.
- Children with Special Needs. If you look after children with special needs PPT's can be an effective way of providing for them in a way that does not stop any benefits the state or local authority may offer.

Accumulation and Maintenance Trust

An accumulation and maintenance trust is often used by parents to benefit their children or grandparents to benefit their grandchildren.
The normal features are as follows.

- In the early years this operates in a similar manner to the discretionary trust, but usually after an initial period income is given to the beneficiaries as of right, as in the life interest trust.
- Capital can be paid out when it is hoped that the recipients are more able to control their finances.
- Capital can be released in earlier years, at the trustees' discretion, if needed to help a beneficiary.

Spendthrift Trust

There may be circumstances where beneficiaries are not able to handle their finances properly. Rather than leave them with a large amount of money at their disposal, the donor can include spendthrift provisions in the trust. These provisions allow the trustee to pay money to third parties for the benefit of the beneficiary rather than to the beneficiary himself or herself, or to withhold all payments when appropriate. For example, the trustee might pay college tuition directly to the school rather than distribute the same amount to the beneficiary. Spendthrift provisions also protect beneficiaries from creditors because if the trustee withholds payments from the beneficiary, his or her creditors cannot attack such payments.

Insurance Trust

While most insurance policies designate a specific beneficiary, you can establish a life insurance trust that becomes the beneficiary. With the payments made to the trust rather than to an individual, the proceeds of the insurance are not included in your estate. Therefore, your estate does not have to pay IHT on the amount of the payment. Life insurance trusts are normally irrevocable trusts and cannot be changed once established.

Tax Issues

Giving property away to trustees (ensuring neither the donor nor their spouse has a benefit) determines the donor's inheritance tax position for that gift.
Gifts to a life interest trust are potentially exempt transfers (PETs) and providing the donor survives seven years from the date of the gift, no inheritance tax is payable. Gifts to an accumulation and maintenance trust are also PETs. There is a potential charge in setting up a discretionary trust but if the gift is below ~£300,000, no tax will be payable.
If assets are transferred to trustees, this is considered a disposal for capital gains tax purposes but in many situations any capital gain arising can be deferred.

Gains within the trust are charged at 34% (6% less than a higher rate taxpayer).

Tax Treatment of Trusts

Life interest trusts are taxed on their income at 10% (dividends), 20% (interest) and 22% (other income).
From 2006 rusts set up to hold assets for minors are taxed broadly as if they are discretionary trusts once the beneficiary reaches the age of 18.
Discretionary trusts (including accumulation and maintenance trusts during the 'discretionary' period) pay tax at 25% (dividends) and 34% (other income).
Income paid to life interest beneficiaries will have a tax credit available with the effect that they will be treated as if they receive the income as the owners of the assets.
If income is released at the trustees' discretion from discretionary trusts, the beneficiaries will receive the income net of 34% tax. They are able to obtain refunds of any overpaid tax and if they pay tax at 40%, they will get credit for the 34% paid.
Inheritance tax may have to be considered during the trust period and each main type of trust is dealt with differently.
Life interest trusts will have to be valued when the income beneficiary dies. The value of the trust assets is added to the value of the beneficiary's personal assets to determine the rate of tax payable, with the trustees being liable to pay the trust share of the inheritance tax due from the assets held.
Discretionary trusts are charged every ten years and by careful planning the value can often be maintained under the taxable limit. Where this is not possible or perhaps desirable, then it should be noted that the maximum tax rate is 6% of the value of the assets in the trust every 10 years.
Accumulation and maintenance trusts do not pay inheritance tax if the funds are released to the nominated beneficiaries.

Capital Gains Tax ("CGT")

The trustees will pay CGT at a flat rate of 34% (subject to any taper relief) in respect of any capital gains exceeding their available annual exemption, presently a maximum of £3,750. Although there will be no uplift in the base value of the assets on the survivor's death for CGT purposes, when they are subsequently distributed it should be possible to defer payment of the tax by an election for hold-over relief.