A Guide to Trusts

What is a Trust?

Trusts

A trust is a legal arrangement where one party (the trustee) holds and manages assets for the benefit of another party (the beneficiary). Trusts are used for various purposes, including estate planning, asset protection, and charitable giving.

Trusts have a long and fascinating history:

- **Roman Era:** The concept of trusts can be traced back to Roman law, where a mechanism called "fideicommissum" allowed property owners to entrust assets to a reliable friend for the benefit of others
- **Medieval England:** Trusts began to take shape during the 12th century, particularly during the Crusades. Crusaders would transfer their lands to trusted friends for safekeeping while they were away
- **Court of Chancery:** The development of trusts was significantly influenced by the Court of Chancery in England, which recognised and enforced these arrangements, establishing the principles of equity that underpin modern trust law

Trusts have evolved over centuries to become a versatile tool in modern asset management and estate planning.

The main types

Interest in Possession Trust

An Interest in Possession (IIP) Trust is a type of trust where at least one beneficiary has the immediate right to receive income generated by the trust assets or to enjoy the trust assets in another way. Here are the key features:

Key Features of Interest in Possession Trusts

1. **Income Beneficiary:**
   - The beneficiary with the right to receive income from the trust is known as the income beneficiary or life tenant
   - This beneficiary receives all income generated by the trust assets, minus any trustee expenses
2. **Capital Beneficiary:**
   - Another beneficiary, known as the capital beneficiary or remainderman, is entitled to the trust's capital assets once the interest in possession ends
3. **Duration:**
   - The interest in possession can be for a fixed period, an indefinite period, or typically for the lifetime of the income beneficiary

Example

Imagine a trust where the dividends from shares are paid to the income beneficiary (e.g., a spouse) during their lifetime. After the spouse's death, the shares themselves are passed on to the children, who are the capital beneficiaries.

Purpose

Interest in Possession Trusts are often used in estate planning to ensure that a surviving spouse can continue to benefit from assets (like living in a family home) while ringfencing and protecting the capital value of the assets and ensuring that those assets pass to children or other beneficiaries.

The main types

Discretionary Trust

A Discretionary Trust is a type of trust where the trustee has the power to decide how to distribute the trust's income and assets among the beneficiaries. Here are the key features:

Key Features of Discretionary Trusts

1. **Trustee's Discretion:**
   - The trustee has the authority to decide which beneficiaries receive payments, how much they receive, and when they receive them.
   - This flexibility allows the trustee to respond to changing circumstances and needs of the beneficiaries.
2. **Beneficiaries:**
   - Beneficiaries are usually named in the trust deed, but they do not have a fixed entitlement to the trust's income or capital.
   - The trustee can choose to distribute assets to one or more beneficiaries or retain them within the trust.
3. **Purpose:**
   - Discretionary trusts are often used for estate planning, asset protection, and tax planning.
   - They can provide for beneficiaries who may need varying levels of support over time, such as children or individuals with special needs.

Example

Imagine a trust set up for a family where the trustee can decide to give more funds to a child who needs extra support for education or medical expenses, while providing less to another child who is financially independent.

Advantages

- **Flexibility:** Trustees can adapt distributions based on beneficiaries' needs and circumstances.
- **Tax Planning:** Trustees can manage distributions to optimise tax benefits for the trust and beneficiaries.
- **Asset Protection:** Assets within the trust are protected from creditors and legal claims against individual beneficiaries.

Discretionary trusts are a powerful tool for managing and protecting assets while providing for beneficiaries in a flexible manner.

The main types

Vulnerable Person's Trust

Eligibility
A vulnerable beneficiary is typically for someone who qualifies for certain benefits, such as Disability Living Allowance, Personal Independence Payment, or Attendance Allowance.

Special Tax Treatment
Trusts for vulnerable beneficiaries can qualify for special Income Tax and Capital Gains Tax (CGT) treatment. This means the trustees can claim deductions that reduce the overall tax liability.

To claim this special treatment, trustees must complete a Vulnerable Person Election form.

Qualifying Trusts
In a Vulnerable Persons Trust, the primary focus is on benefiting the vulnerable beneficiary. However, there is limited scope for other beneficiaries to receive payments from the trust. The annual limit for payments to other beneficiaries is the lower of £3,000 or 3% of the trust fund.

Example
Imagine a family setting up a trust for their child, Emma, who has a severe disability and qualifies for Disability Living Allowance. The parents want to ensure that Emma is financially supported throughout her life without affecting her eligibility for government benefits.

Trust Setup

1. **Trustees:** Emma's parents appoint themselves and a trusted family friend as trustees.
2. **Beneficiary:** Emma is the primary beneficiary of the trust.
3. **Assets:** The trust includes various assets, such as cash, investments, and property.

Trust Provisions

- **Income and Capital**: The trustees have discretion over how to distribute the trust's income and capital. They can decide to use the funds for Emma's medical expenses, education, and daily living costs.

The main types

Vulnerable Person's Trust

- **Special Tax Treatment:** The trustees complete a Vulnerable Person Election form to claim special tax treatment, reducing the trust's overall tax liability.
- **Limited Payments to Others:** The trust allows limited payments to other beneficiaries, up to the lower of £3,000 or 3% of the trust fund annually.

Benefits

- Financial Security: Emma receives the necessary financial support without jeopardising her eligibility for means-tested benefits.
- Flexibility: Trustees can adapt distributions based on Emma's changing needs and circumstances.
- Protection: The trust assets are protected from creditors and legal claims.

This example illustrates how a Vulnerable Persons Trust can provide tailored financial support and protection for a vulnerable beneficiary.

Purpose

Vulnerable Persons Trusts are often used to ensure that individuals who cannot manage their own finances due to disability or other reasons are adequately supported. They provide a secure way to manage and protect assets for the benefit of vulnerable individuals.

Trusts for Minors and Young Persons

As the rules for setting up trusts for minors varies depending on who sets the trust up, we have prepared a separate guide – please let us know if you would like a copy.

Key Changes in 2006

Trusts

In 2006, significant changes were made to the inheritance tax (IHT) treatment of trusts in the UK, particularly affecting Interest in Possession (IIP) and Accumulation and Maintenance (A&M) trusts. These changes were introduced through the Finance Act 2006 and came into effect on March 22, 2006.

Inheritance Tax Treatment:

- **Pre-2006 Trusts:** Before March 22, 2006, lifetime transfers into IIP and Accumulation & Maintenance trusts were generally exempt from IHT, provided the settlor survived for seven years. These trusts were not subject to the 10-yearly periodic charge or the exit charge typically associated with discretionary trusts
- **Post-2006 Trusts:** Trusts created on or after March 22, 2006, are subject to the relevant property regime (RPR). A relevant property trust is a trust which does not qualify for any other tax treatment. This would be trusts which are not Qualifying Interest In Possession, Trusts created for bereaved minors and young people and charitable trusts. The most common type of relevant property trust is a Discretionary Trust. This means they are liable for entry charges, 10-yearly periodic charges, and exit charges.

Entry charge

In lifetime, when assets are transferred into trust, there may be an entry charge based on the value of the assets. The entry charge is 20% on any value above the available nil rate band of the person settling the assets into trust. The full nil rate band available to an individual is £325,000. The entry charge does not apply to assets put into a trust through a will on death.

Periodic Charge

This is a charge on the value of the trust fund at each 10 year anniversary of when it was created. It is a charge of the percentage of the value of the trust at the 10 year anniversary. The calculation for this can be complex but it can never exceed 6%. There will be no charge if the trust capital is below the nil rate band.

Key Changes in 2006

Trusts

The basis of anniversary charges is that it should approximately produce the same amount of inheritance tax as if assets remained in personal ownership and were transferred once every generation.

Exit charge

This is a charge on a reduction in value of the trust fund of a relevant property trust. It will be charged in two circumstances:

1. When trustees distribute assets (unless assets are distributed to another relevant property trust)
2. Assets cease to be relevant property but are still held in trust, for example the trustees make an appointment that qualifies as a disabled person's interest.

The charge is based on the number of quarters that have elapsed since the trust's creation or since the last 10 year anniversary of its creation. There are no charges if the trust is below the nil rate band.

Exit charges only apply to trust capital and do not apply where income is distributed to a beneficiary, however this may give rise to income tax charges.

The role of a Trustee

Trusts

A trustee plays a crucial role in managing and administering a trust for the benefit of its beneficiaries. Here are the key responsibilities and duties of a trustee:

Key Responsibilities of a Trustee

Fiduciary Duty:
Trustees have a fiduciary duty to act in the best interests of the beneficiaries. This means they must manage the trust assets responsibly and ethically.

Asset Management:
Trustees are responsible for managing the trust's assets, which can include investments, property, and other financial assets. They must ensure these assets are preserved and grown according to the trust's terms.

Distribution of Assets:
Trustees must distribute the trust's income and principal to the beneficiaries as specified in the trust deed. This includes making decisions about when and how much to distribute.

Registration:
Trustees are responsible to ensuring the Trust is registered with HMRC within three months of creation through the Trust Registration Scheme (TRS).

Record Keeping:
Trustees must keep accurate records of all transactions, including income, expenses, and distributions. This is essential for transparency and accountability.

Tax Reporting:
Trustees are responsible for filing tax returns for the trust and paying any taxes due. This includes income tax, capital gains tax, and inheritance tax.

The role of a Trustee

Trusts

Communication:
Trustees must communicate regularly with the beneficiaries, providing updates on the trust's status and any decisions made.

Choosing a Trustee:
Selecting the right trustee is crucial. Trustees can be individuals, family members, friends, or professional entities such as lawyers or financial institutions.

It's important to choose someone who is trustworthy, capable, and willing to take on the responsibilities.

Example
Imagine a trust set up for a child’s education. The trustee would manage the trust assets, ensure they are invested wisely, and make distributions to cover educational expenses as needed. They would also keep detailed records and file necessary tax returns.

Trustees play a vital role in ensuring that the trust operates smoothly and fulfils its intended purpose.

Glossary

Trusts

Beneficiary:
The person or entity entitled to receive benefits from the trust.

Settlor:
The individual who creates the trust and transfers assets into it.

Trustee:
The Legal Owner of the Trust and the person or entity responsible for managing the trust assets and carrying out the terms of the trust.

Trust Deed (Trust Instrument):
The legal document that establishes the trust and outlines its terms and conditions.

Testamentary Trust:
A trust established through a will and takes effect after the Testator's death.

Discretionary Trust:
A trust where the trustee has the discretion to decide how to distribute income and assets among the beneficiaries.

Interest in Possession Trust:
A trust where at least one beneficiary has the immediate right to receive income from the trust assets.

Vulnerable Person's Trust:
A trust designed to provide for beneficiaries with disabilities without affecting their eligibility for government benefits.

Charitable Trust:
A trust set up to benefit a charitable organisation or purpose.

Fiduciary Duty:
The legal obligation of the trustee to act in the best interests of the beneficiaries.

Trust period:
125 years

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