Use of Trusts

What are Trusts?

Trusts enable assets to be given away whilst still retaining some control over them. Income can be paid to several different persons with the capital ultimately going to other persons.

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 those years.

A person who transfers property into a trust is called a settlor. Persons who enjoy income or capital from a trust are called beneficiaries.

Types of Trusts

There are two basic types of trust:

- life interest trusts
- discretionary trusts.

An accumulation and maintenance (A&M) trust is effectively a hybrid of these basic types.

Life interest trusts

A life interest trust has the following features:

- a nominated beneficiary has an interest in the income from the assets in the trust or has the use of trust assets. This right may be for life or some shorter period (perhaps to a certain age)
- the capital may 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 has the following features:

- no beneficiary is entitled to the income as of right
- the settlor gives the trustees discretion to pay the income to one, some or all of a nominated class of possible beneficiaries
- income can be retained by the trustees for up to 21 years
- capital can be gifted to nominated individuals or to a class of beneficiaries.

A&M trusts

An A&M trust is often used by 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) at 18 at the earliest or at 25 at the latest
- 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 it is needed to help a beneficiary.

There are sometimes difficulties in drafting A&M trusts to meet certain legal trust requirements. Until now the tax advantages of an A&M trust have tended to outweigh those problems.

Inheritance Tax Consequences

Discretionary trusts

If a discretionary trust is set up in lifetime this gives rise to an immediate charge to inheritance tax but at the lifetime rate of 20%. If the value of the gift (and certain earlier gifts) is below £285,000 (£300,000 for 2007/08) no tax is payable. Discretionary trusts set up under a will attract the normal inheritance tax charge at the death rate of 40%.

Discretionary trusts are charged to tax every ten years (known as the periodic charge) at a maximum rate of 6% of the value of the assets on each tenth anniversary of the setting up of the trust. By careful planning the value can often be maintained under the taxable limit.

Finally there is an 'exit' charge if assets are appointed out of the trust.

Whilst, therefore, discretionary trusts can be very flexible, their tax treatment is designed to give broadly the same charge to tax, over the life of the trust, as would have arisen had the property been held by individuals.

A&M trusts

Until 22nd March 2006 an A&M trust set up in lifetime was a potentially exempt transfer (PET) and no inheritance tax would be payable if the settlor survived for 7 years. In addition, once on trust, there was no periodic charge nor was there an exit charge. For this reason such trusts were a very useful planning device.

For A&M trusts set up after 22 March 2006 this favourable treatment will no longer apply. If the trust was created on death by a parent for the benefit of a minor child who is entitled to the trust assets absolutely at 18, the periodic charge will be avoided but there will be a charge on creation.

Existing A&M trusts have until 6 April 2008 to make changes. If, by that date, the trust provides that income and capital will be paid out when a beneficiary reaches the age of 18, then the existing tax treatment can continue. However, if the trust fails to meet these requirements it will be treated in the same way as a discretionary trust. Although the entry charge will have been avoided, there will be a periodic charge on the first ten year anniversary of the trust after 6 April 2008 and on all subsequent tenth anniversaries. There will also be an exit charge when capital is distributed out of the trust.

Life Interest trusts

Until 22 March 2006 a lifetime transfer into a life interest trust was a potentially exempt transfer (PET) and no inheritance tax would be payable if the settlor survived for 7 years. There was then no periodic charge on such trusts but there was a charge to inheritance tax if the life interest came to an end, eg if the life tenant died, the assets of the trust were included in his or her estate for inheritance tax purposes.

For life interest trusts set up after 22 March 2006, these rules will no longer apply unless:

- the trust was created under the terms of a will and gives an immediate interest in the income to a beneficiary with strict conditions as to what happens to the property at the end of the interest; or
- the trust is created in the settlor's lifetime or on death for a disabled person.

In the first case, the property, at the end of the first beneficiaries interest, must pass to a person absolutely (ie the assets are distributed to them) or must be given to a charity or be put onto another qualifying trust (eg a trust for a disabled person).

Unless the trust meets these conditions, it will be treated in the same way as a discretionary trust.

This now means that any trust created in the settlor's lifetime may be chargeable to inheritance tax unless it is set up for the benefit of a disabled person.

There are transitional rules for trusts already in existence at 22 March 2006. We would be happy to provide further advice and information on this complex area.

Capital Gains Tax Consequences

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 40%. Trustees can also claim business asset taper relief in appropriate situations.

Income Tax Consequences

Life interest trusts are taxed on their income at 10% (dividends), 20% (interest) and 22% (other income). Discretionary trusts (including A&M trusts during the 'discretionary' period) pay tax at 32.5% (dividends) and 40% (other income). Income paid to life interest beneficiaries has an appropriate tax credit available with the effect that the beneficiaries are 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 40% tax. They are able to obtain refunds of any overpaid tax and if they pay tax at 40%, they will get credit for the tax paid.

Which Trust is Right for Me?

The problem

To provide for your family's financial needs in a way that permits maximum flexibility during a period of years with a minimum tax burden.

Possible solution

Discretionary trust.

The problem

To make gifts now but you are undecided how much to give each donee.

Possible solution

Discretionary trust.

The problem

Making a gift to start your seven year inheritance tax gift clock running but extra thinking time is needed before deciding who should receive what.

Possible solution

Discretionary trust.

The problem

To make gifts to children or grandchildren.

Possible solution

Discretionary trust.

The problem

To make a gift of income to a particular individual but retaining control over what happens to the capital after the death of that individual.

Possible solution

Life interest trust.

How We Can Help

This factsheet briefly covers some aspects of trusts. If you are interested in providing for your family through the use of trusts we recommend that you talk to us.

We will be more than happy to provide you with additional information and assistance.