



technical factsheet 80

Trusts 1

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This is the first in a series of factsheets dealing with establishing, running and the use of trusts. This initial factsheet is intended to provide the user with an introduction to the types of trusts and their implications. It is not intended as a source of advice on the topic.

This factsheet is for guidance purposes only. It is not a substitute for obtaining specific legal advice. Whilst every care has been taken with the preparation of this factsheet neither ACCA nor its employees accept any responsibility for any loss occasioned by reliance on the contents.

WHAT IS A TRUST?

- 1 A trust is an arrangement whereby a person (the Settlor) transfers property to one or more persons (the Trustees) for the benefit of one or more persons (the Beneficiaries). To create a valid trust there must be three 'certainties':
 - the intention to create a trust
 - the property settled
 - the beneficiaries.
- 2 It is possible to create a trust unintentionally, or for a trust to fail because the intention is not sufficiently clear and it is therefore important that professional assistance is obtained when the trust is drafted. The Settlor is usually named, but it is also possible to become a Settlor unintentionally, so there may be more than one Settlor. These matters are discussed below.
- 3 It is not necessary for the beneficiaries to be named - they can be defined as a class e.g. the children of X born before 30 June 2010.
- 4 The trustees therefore have the legal ownership of the assets and the beneficiaries have the beneficial ownership. It is possible for the Settlor to be a trustee or a beneficiary of a trust, but it is not advisable as, if he retains too much control, the trust may be deemed to be a 'sham'. If he is a beneficiary, he will fall foul of a lot of anti-avoidance legislation for tax purposes (see *Midland Bank plc v Wyatt* [1994] EGCS 113).

DEFINITIONS

- 5 Trusts have a jargon of their own, the principal terms of which are:

Settlor - a person who provides funds for the creation of, or addition to, the trust fund

Trustee - a person who takes legal ownership of the trust property and holds it for the benefit of the beneficiaries

Settlement - a trust set up in the Settlor's lifetime, although the term encompasses arrangements other than trusts

Trust Deed - the document setting out the terms of the trust, its duration, the beneficiaries and the initial trust fund

Beneficiary - someone who can or will benefit from the trust property or income

Life tenant - someone who is entitled to the income of the trust for his lifetime, although the term is sometimes used for an income beneficiary who has a right to the trust income for a different term

Remainderman - the person entitled to the capital of the trust, often but not necessarily, on the death of the life tenant.

TYPES OF TRUST

- 6 There are three basic types of trust:
 - Bare trust - essentially a nominee arrangement
 - Interest in possession trust
 - Discretionary trust.

These types of trust will be discussed in greater detail in forthcoming factsheets.

- 7 Other types of trust are to be found, e.g. Accumulation and Maintenance Trusts, Protective Trusts, Reverter to Settlor Trusts, but these are variations on the above.

WHY MAKE A TRUST?

- 8 Common reasons to make a trust are to retain assets in a family or to provide for future generations. This would be the case where a husband and wife wanted to provide for each other for their lifetime, with their children and grandchildren to benefit in future years.
- 9 Lifetime trusts are also useful where assets are held abroad, to avoid the necessity to obtain probate in numerous jurisdictions.
- 10 Other reasons are to protect assets from irresponsible or incapacitated beneficiaries, postponing a decision as to which beneficiaries to benefit, in case they marry unwisely or come under the influence of fortune hunters.
- 11 Trusts can also be used as a convenient way of holding assets for a number of named persons. They are also used in tax planning, but there are numerous anti-avoidance provisions to combat abuse and in this context are more useful where the parties involved are non-UK domiciled and the trust is resident offshore.

HOW DO YOU FORM A TRUST?

- 12 Trusts are often created during a person's lifetime by settlement, by deed, the beneficiaries or potential beneficiaries being named in the trust deed, or identified by reference to it. Perhaps as often, they are created on the death of a testator, by his will. They can also arise by operation of law e.g. by the intestacy rules, when the deceased has not made a valid will or when a trust deed is not sufficiently clear and the property becomes held on resulting trust for the Settlor.

BARE TRUST

- 13 A bare trust is a nominee arrangement, where the trustee is the legal owner and the beneficiary is the beneficial owner and is absolutely entitled to the capital and income arising. The beneficiary can require the trustee to transfer the property to him at any time. This type of arrangement is frequently used for share holding e.g. by a stockbroker for a client with frequent transactions or as part of an ISA investment.
- 14 Another occasion would arise where the beneficial owner is a minor and unable at law to give a valid receipt.
- 15 The beneficiary is taxable on any gains arising in the trust, as his own gains. He is normally chargeable to income tax on any income, except where the income arises from assets transferred by a parent and the child is under 18 (in England and Wales). In that case, the income would be assessable on the parent and taxed as the parent's income, until the child attained the age of 18.

INTEREST IN POSSESSION TRUST

- 16 An interest in possession trust confers 'a present right to present income'. The persons entitled to the interest in possession are frequently referred to as the life tenant(s), as they are commonly entitled to the income for the duration of their lifetime, although this is not necessarily the case. The entitlement may be for a specified term of years, or for the duration of another person's life.
- 17 There is not necessarily only one life tenant, there may be several concurrently, or successively. The details will be set out in the trust deed.
- 18 The trust deed will also set out the entitlement to the trust capital. On the expiry of the last interest in possession, the remainderman will become absolutely entitled to the trust capital.

- 19 There are thus two types of beneficiary of an interest in possession trust: the income beneficiary and the capital beneficiary or remainderman. The trustees have a duty to act in the best interest of the beneficiaries and it is clear that they can have a difficult task trying to balance the different interests of income or capital beneficiaries i.e. investing for income or growth.
- 20 The trustees of an interest in possession trust act in a purely representative capacity and the income of the trust is charged to income tax within the trust without the benefit of personal allowances or lower or higher rates of tax and without any deduction for trustees' expenses. Thus bank interest is currently taxed at 20%, dividend income carries a 10% tax credit and other income, e.g. rental income bears tax at 22%. The trust is not chargeable to tax at the higher rates.
- 21 The income beneficiary is entitled to the income as it arises and is taxed upon the income by reference to his own tax position. He will, if appropriate, be assessed to tax at the higher rates, with credit given for the basic rate tax on that income paid by the trustees. General administration expenses are paid out of taxed income but will be deductible from trust income otherwise assessable to higher rate tax. There is a specific order of set-off of expenses against the various sources of income for this purpose.
- 22 *Example:*
The James Trust has net income of £120 which comprises bank interest of £150 from which tax of £30 has been deducted at source. Trust administration expenses of £40 have been deducted. J, the life tenant, is therefore entitled to the net income, after expenses of £80. He is a higher rate tax payer and is assessable to income tax on $(£80 \times 100/80) = £100 @ 40\%$ i.e. £40 less credit for $(£100 @ 20\%) = £20$ deducted at source.
- 23 As far as the capital is concerned, the income beneficiary has no interest in the capital of the trust and is therefore largely irrelevant for capital gains tax. There are two exceptions; the first is taper relief. Provided the beneficiary is an 'eligible beneficiary', i.e. a beneficiary with an interest in possession and the trustees hold at least 5% of the voting rights, the company may qualify as a business asset for taper relief. The second exception is the death of a life tenant. On the occasion of the death of a life tenant, the trustees are deemed to dispose of and reacquire the assets producing the income (or his share of the income) at market value. There is no charge to tax on this deemed disposal, i.e. it is a 'tax free uplift' in the base cost for capital gains tax. The situation is different for inheritance tax; on the death of a life tenant the assets of the trust (or underlying his interest in the trust) are deemed to form part of his estate and will be chargeable to inheritance tax.
- 24 Disposals of chargeable assets by the trustees will give rise to a chargeable gain or allowable loss. The trustees are deemed for this purpose to be a single body of persons and have available an annual allowance for capital gains tax. This is normally half the individual's annual allowance (£3850 for 2002/03), but if the Settlor has made other settlements since 6 June 1978, the figure will be divided by the number of settlements.

DISCRETIONARY TRUST

- 25 As its name implies, there is not normally a specific entitlement to income from a discretionary trust. Distributions of income and/or capital are at the discretion of the trustees. As with any other trust, the potential beneficiaries are defined in the trust deed and any distributions to them are decided by the trustees. The only right that the beneficiaries have is that the trustees administer the trust properly and act in the best interests of the beneficiaries generally. There is no requirement for income to be distributed, it can be accumulated and added to the capital of the trust. They are particularly useful in the context of a family, where it is not known what the individual beneficiaries' needs will be, or where shares in a family company are to be held and it is not known what the next generation's management abilities will be.
- 26 Discretionary trusts have in the past been used for tax avoidance and they are now taxed more harshly than other trusts. This is not necessarily a problem, as it may be possible for the tax to be recovered by the beneficiaries. The income of a discretionary trust is charged to income tax currently at the rate of 34%, except in the case of dividend income which is currently taxed at 25%. General trust expenses can be offset against this income in calculating the tax charge, although the mechanics are different from those of a life interest trust. A distribution of income to a beneficiary would carry the appropriate tax credit, subject to there being sufficient in the 'tax pool',

i.e. credits for tax paid by the trustees. Capital gains are taxed at 34% and have been for several years, as are those of the interest in possession trust.

- 27 Inheritance tax rules are more severe for a normal discretionary trust. A transfer into a discretionary trust is a chargeable transfer for inheritance tax and in the case of a lifetime settlement will, at least initially, be charged at the lifetime rate. Additionally, every 10 years, the assets are valued and charged to tax at 30% of the lifetime rate.
- 28 Any capital distributions from the trust will also incur an inheritance tax charge, unless the distribution takes place immediately after the ten-year charge.

ACCUMULATION AND MAINTENANCE TRUSTS

- 29 Accumulation and maintenance trusts (A&M trusts) are a type of discretionary trust, but are treated much more favourably for tax purposes. The usual reasons for forming them are to retain assets within the family. The essentials of an A&M trust are:
- a no beneficiary has an interest in possession in the trust property initially, i.e. no one is entitled as of right to the income
 - b one or more persons (qualifying beneficiaries) will become entitled to the property, or to an interest in possession in it, by the age of 25
 - c meanwhile, the income is either accumulated or used for the maintenance, education or benefit of a qualifying beneficiary
 - d either
 - all the beneficiaries are grandchildren of a common grandparent; or
 - the settlement terminates or continues as an interest in possession trust not more than 25 years after its creation
 - e there must be at least one beneficiary living at the date of creation of the trust.
- 30 The income tax and capital gains tax implications are the same as for an ordinary discretionary trust. Inheritance tax legislation is much more generous to an A&M trust than to a basic discretionary trust.
- 31 The initial transfer to an A&M trust is not a chargeable transfer for inheritance tax, it is a potentially exempt transfer (it does not become chargeable unless the transferor dies within 7 years of the transfer) and there is no ten-year charge. The transfer out of an A&M trust is a chargeable transfer for inheritance tax, but no charge to tax arises if the beneficiary becomes entitled to the property, or to an interest in possession in it, on or before attaining the specified age.
- 32 For example - John is a beneficiary of The John Trust, which is an A&M trust. He becomes entitled to his share of the trust (capital and income) when he is 18. There will be no charge to inheritance tax, because he has become entitled to his share on attaining the specified age. Any gains on the assets can be held over for capital gains tax purposes, until John disposes of them.
- 33 The transfer into the trust would be a chargeable event for capital gains tax, but a gain on a transfer out of the A&M trust, provided it has not become an interest in possession trust, i.e. no beneficiary has become entitled to the income, can be held over until a later disposal by the beneficiary.

WHAT DOES IT COST TO FORM A TRUST?

- 34 It is essential that a settlement is drawn up by a properly qualified person. By working in conjunction with a lawyer to draw up an appropriate trust deed, apart from the initial set up costs, a trust can be run remarkably cheaply. The type and amount of costs will naturally depend upon the trust assets but would typically be portfolio management costs if the trust had a share portfolio, bank charges and of course, accounts preparation and tax return submission.
- 35 As can be seen from the descriptions of each type of trust, they can be a useful tax planning tool for the family run business. However, the taxation of trusts is a specialist field and, if you are not confident of this subject, take specialist advice.

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Issued 03/03