A Guide to Trusts

Trusts are a powerful legal tool that can be used for a variety of purposes in the UK. They can be used to avoid probate, protect assets from creditors, minimize taxes, and provide for the financial needs of loved ones.

This guide will provide you with an overview of trusts in the UK. We will discuss the different types of trusts, how they work, and the benefits of using them.

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What is a Trust?

Some people feel uncomfortable when we suggest trusts, especially when we recommend pairing them with an 'offshore bond' as we often do. This is partly because trusts are usually an unknown and abstract concept which makes them hard to understand, and partly because they (along with offshore investment structures) get a lot of bad press.

Whilst trusts certainly can be used to conceal illicit financial arrangements (both offshore and on), they do have plenty of legitimate uses. These can include protecting the financially vulnerable, ensuring your wealth stays in your own bloodline, and even creating a legacy that benefits the people/things that matter to you long after you've gone.

To write off trusts for their bad press is to throw the baby out with the bathwater – trusts have been a legitimate part of our legal system since the days of knights in shining armour.

To give a brief overview, a trust is a bit like a company in that it has its own legal identity separate from any individual involved. The person(s) that creates the trust is the *settlor*, the person(s) responsible for managing the trust are *trustees*, and the person(s) benefitting from the trust are the *beneficiaries*. The trust can own assets in its own name and those assets do not belong to the settlor, trustees or beneficiaries, but the trustees are legally responsible for managing those assets diligently for the benefit of the beneficiaries in line with the requirements of the trust.

Just to illustrate how simple trusts can be, if I see my sister and say "here's some cash, take mum out for dinner when you next have an evening free" then, technically speaking, we have done everything needed to establish a basic trust: I am the settlor, my sister is the trustee, my mum is the beneficiary, and we needn't even draw up a deed to make it legitimate in law (although deeds are always advisable). Of course, few trusts are this simple, but this thought exercise provides a helpful basis to build upon when trying to conceptualise how trusts work.

Trusts and IHT at outset

When assets are settled into trust, they no longer belong to the settlor. Provided the settlor has no ongoing enjoyment of the assets and no right to benefit from the trust (i.e. provided the settlor is not also a beneficiary), settlements into trusts can be gifts for IHT purposes.

The type of gift (and therefore the tax treatment) depends on the type of trust. There are many types of trust, but they can be broadly categorised into bare trusts (aka absolute trusts), discretionary trusts and interest in possession trusts.

In a bare trust, the trustees have no discretion over who the beneficiaries are, how much they receive, or when they receive it, so the named beneficiaries have an absolute entitlement to receive their share at a specified time. Gifts into these trusts are Potentially Exempt Transfers (PETs), which were covered in our guide to IHT allowances.

In a discretionary trust, no one has an absolute right to benefit from that trust. Whilst certain people may be named as beneficiaries, the trustees have power to decide who can benefit, when, and how. Gifts into discretionary trusts (excluding those set up for a vulnerable person) are Chargeable Lifetime Transfers (CLTs). CLTs use up a person's Nil Rate Band (NRB, currently £325,000) for the seven years following the gift, and any CLTs exceeding a person's available NRB (considering any CLTs in the 7 years prior) suffer a lifetime tax charge of 20% of the excess over the NRB. You cannot use any

inherited/transferred NRB for CLTs, nor can you use any Residence Nil Rate Band (RNRB). Furthermore, if death occurs within 7 years, the CLT is reassessed, and further tax may be payable.

Interest in possession trusts created after 22 March 2006 are like discretionary trusts in the tax treatment of gifts into the trust, however an interest in possession trust has a life tenant who has entitled to (normally) the income from the trust during their lifetime. These trusts are often used to provide financial security to a spouse, or an individual during their lifetime, whilst ensuring the capital is protected for other beneficiaries, often children or grandchildren.

PETs and CLTs can interact in complex ways and adverse outcomes may arise if different types of gifts are done in the wrong order, so you should seek advice before making substantial gifts or settlements to trusts.

Trusts and tax over time

The tax treatment of a trust over its lifetime also depends on whether it is a bare or discretionary trust. Bare trusts are generally taxed as though they belong to the beneficiary using the tax rates and allowances applicable to that individual. Discretionary trusts suffer tax at trust rates, have tax allowances specific to trusts, and are generally subject to the Relevant Property Regime.

As a rough overview, the tax rates for discretionary trusts are currently the same as an Additional Rate taxpayer (45%/39.35%/20%), the allowances are smaller than for individuals, and there may be up to 6% payable in IHT every 10 years and whenever money is taken from the trust. Whilst this may all look rather punitive and off-putting, many of these taxes can be minimised or avoided entirely with the right planning.

If the trustees of an interest in possession trust choose to mandate the income directly to the beneficiary they will not need to report it on the trust tax return. However, trustees will not be able to deduct any expenses from mandated income.

If investment income is not mandated to the beneficiary then the trustees are liable for income tax at the basic rate regardless of how much or how little income arises (dividend income - 8.75%, all other income - 20%). The personal allowance, personal savings allowance and the dividend allowance are not available to the trustees.

The trustees are only entitled to half the individual annual CGT exempt amount. However, this exemption is shared equally between all trusts created by the same settlor, subject to a minimum of one fifth of the trust exemption.

Trustees can also claim principal private residence (PPR) relief on the disposal of residential property that has been occupied by a beneficiary of the trust as their only or main residence.

What trusts are available?

Now we have some basic understanding of trusts, we can explore some of those commonly used for reducing IHT. We will start with gift trusts – these are about as simple as it gets and they can be set up on a bare or discretionary basis, each of which is considered in turn in the sections that follow. Thereafter, we look at discounted gift trusts (DGTs) and gift & loan trusts (sometimes just called loan trusts). There are undoubtedly more, but these are the most commonly used.

Bare gift trusts

Settlements to bare gift trusts are PETs, meaning you could settle as much as you like with no IHT to pay in your lifetime and no IHT at all if you live 7 years beyond the date of the PET, and any tax on the trust would be assessed against the beneficiary. This is especially useful if the beneficiary is young and/or has low or no taxable income of their own, as even a newborn has all the tax allowances afforded to an adult. These are a great option if you wish to invest for a minor without the constraints of Junior ISAs or junior pensions and without increasing your own tax burden.

The drawbacks are the beneficiary can demand the assets of the trust from age 18, as can any adverse creditors (meaning this trust lacks the protection and control of other trusts). You must relinquish all access to the capital if it is to be effective for IHT.

Discretionary gift trusts

Settlements into discretionary gift trusts are CLTs, meaning you could put up to £325,000 into one of these trusts (assuming no other gifts) with no immediate tax to pay. This will use your NRB but once 7 years has elapsed (provided you are still alive) the CLT will fall out of consideration, and you will have a full NRB available to use again. As such, you could repeat this exercise every 7 years as needed.

The main drawback of this trust structure, beyond the constraints of CLTs, are the high taxes that can apply. However, the use of investment bonds within the trust would relieve the trustees of the need for annual trust tax returns and defer tax liabilities; it also allows the trustees to assign the bond (or parts thereof) to the beneficiaries which, when coupled with the deferment of taxes, creates interesting planning opportunities for minimising tax.

The trustees will have complete discretion over who receives assets and when, but you can guide them by providing a 'letter of wishes'. As with the bare gift trust, you must relinquish all rights to the capital to be effective for IHT.

Discounted Gift Trusts (DGTs)

These are particularly useful for those reliant on their capital to provide an income in retirement. They work by the settlor retaining a right to regular payments from the trustees for the rest of their life. The trustees invest the lump sum, and the regular payment is paid by setting up regular withdrawals from the investments. These regular payments do not form part of the settlor's estate because the right to them ceases upon death.

The amount gifted for IHT is reduced by the actuarial value of these 'retained rights', and the age and health of the settlor are factored into this (with younger settlors generally receiving bigger discounts unless they are in poor health, in which case, the discount could be reduced or even disallowed).

This discount provides an immediate reduction in an IHT liability and also means larger amounts can be given away without a lifetime IHT charge, provided the gifted value (after discount) is less than the available nil rate band.

Gift and loan trusts

These trusts provide a 'halfway house' for those who, for whatever reason, may not be willing or able to fully commit to giving up assets. In essence, a nominal amount (e.g. £10) is settled to create a trust, and the settlor can then make a loan to the trustees.

The loan can be as big as required; its value always remains part of your estate, but if the trustees invest the loan for the benefit of the beneficiaries then any growth on those investments belongs to the trust and is immediately outside your estate. As such, this will not reduce your current IHT liability, but it will stop investment growth making your liability worse over time.

You can also retain the option to recall the loan (in full or in part) at any time, meaning you can get the capital back if an unforeseen need should arise (e.g. if you need to pay for care).

Wealth Preservation Trusts (aka Wealth Preservation Accounts)

This article would be incomplete without at least mentioning Wealth Preservation Trusts, which is a powerful but highly complex tool for reducing IHT without committing to an outright gift.

It uses a combination of discretionary trusts to make a chargeable lifetime transfer (which will be outside your estate for IHT after 7 years) whilst still allowing some access to the capital and investment growth within the trust without undoing the IHT benefits. It does this via a series of life policies set to mature at annual intervals; at maturity, you can allow the policies to mature if you need the money (and pay Income Tax on any investment growth), or defer maturity.

The main advantage over a loan trust is the settlement leaves your estate after 7 years; the main disadvantage is you only have access at maturity, so forward planning is required as access is not available on demand (unlike a loan trust). There is great flexibility in distributing the wealth to beneficiaries and the trust can survive many generations. If you think this trust might appeal and would like more information, please get in touch.

Other uses of trusts

We have so far focused on how trusts can be used to manage IHT, but the control and protection offered by trusts can be used to meet other objectives too.

For example, if assets are given to a person, that person owns them and can use them as they like regardless of your wishes; by contrast, assets settled into trust belong to that trust, and the trustees are legally responsible for managing those assets for the benefit of all beneficiaries. Discretionary trusts, in particular, can thereby protect wealth from being lost through divorce, bankruptcy, or irresponsible behaviour.

The option of adding 'life tenants' allows another interesting layer of control. A life tenant is someone with a right to benefit from the assets and income of a trust for as long as they live, but they are not entitled to the value of those assets and nor is anyone else whilst the life tenant lives. On death of the life tenant, the assets can be used for the benefit of the 'remaindermen'. Trusts with life interests become especially useful for couples with children from previous relationships: they allow each person to ensure their partner lives comfortably for the rest of their life, whilst ensuring only their own children ultimately inherit their wealth.

Trusts can also reduce the impact on familial wealth of having to pay for care. A person is generally required to fund their own care until all their wealth is virtually spent. As such, if a widow or widower inherits all their spouse's assets on death, their combined wealth could be exhausted funding the survivor's care needs meaning nothing is left for the children to inherit. Conversely, if the deceased's assets had been left into the right type of trust, the widow/widower could still benefit from those assets but the local authority would be unable to force their sale to fund care. Whilst this does not protect assets owned by the person needing care, it does ensure at least a portion of the inheritance is preserved.

Lastly, you can stipulate 'classes of beneficiary', as well as naming individuals. In this way, you can give gifts to grandchildren who are yet to be born! Even a grandchild born years after your own death could benefit from such a trust.

Administration

Given the responsibilities of trustees, the tax treatment of trusts, and the potential for trusts to be used nefariously, it should be no surprise that there are administrative duties involved in running a trust.

For example, new rules came into force relatively recently which now requires all trusts to be registered with the Trust Registration Service (TRS) within 90 days. There are exemptions but these are relatively few, and every trust covered in this document would likely need to be registered. Trustees must also provide updates to the TRS within 90 days of anything changing within the trust.

Trust assets must be kept separate from personal assets, meaning trustees may have to open and maintain separate bank accounts for the trust. If trust assets earn interest, dividends or capital gains, the trust must be registered with HMRC and a trust tax return will be required.

Trustees may require professional advice in the running of the trust, which Lexington can help with. The responsibility of the trustees to the beneficiaries make it prudent to keep records of actions taken and decisions made, which could necessitate conducting and minuting periodic meetings of the trustees.

These requirements must be considered not only when deciding if the benefits of a trust outweigh the drawbacks, but also when selecting trustees. Trustees will need a certain level of knowledge, willingness, and of course, trustworthiness, if they are to do the job properly. It is possible (and sometimes advisable) to appoint at least one professional trustee, but this is not always necessary.

Conclusion

Trusts are undoubtedly complex, but the benefits can be vast for the right situation. We are able to advise upon and set up many types of trust, so if you feel you might value some of the benefits highlighted in this document then get in touch and we will gladly explore this further with you.

Contact Lexington to discuss your plans to discover how we can help with your trusts and inheritance tax planning.

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