

TAX PLANNING WITH TRUSTS

Any client to whom the use of a trust is recommended for the first time could be forgiven for a sense of trepidation in the light of a whole range of new terms thrown at him or her.

The purpose of this Memorandum is, firstly, to set out in simple terms what a trust is and explain some of the terminology commonly employed in different types of trusts. Secondly, the Memorandum considers some of the benefits and possible disadvantages of a trust. Finally, examples are provided of how a particular trust might be utilised in different tax planning contexts.

WHAT IS A TRUST?

The law of trusts traces its origins from medieval times in one of the King's Courts known as the Court of Chancery. The distinct principles or remedies that particular Court developed over the centuries, contrasted with the common law Courts, came to be known as equitable or in equity. Matters involving trusts will nowadays be dealt with by the Chancery Division of the High Court. A solicitor or barrister who specialises in this area will often be called a Chancery or Trust Lawyer, although a solicitor's firm will call the department which deals with this work, typically: The Trust and Probate department.

The most common characteristic of a trust is that it is a relationship in which one person, or persons, normally called a trustee, or trustees, is the legal owner of property held for the benefit of another person, or persons, normally called a beneficiary, or beneficiaries.

There are two main forms of trusts; trusts for sale and strict settlements which are rarely created these days. Notwithstanding this distinction, it is common to describe a trust as a settlement, and, vice versa. The person who creates a trust, and usually gives property to it, in the first instance, is known as a settlor.

It is preferable and good practice to bring a trust into existence using a written trust instrument. The document normally defines the initial trustee or trustees and sets out the rights and duties that the trust gives to them. The nature of these rights can be divided between 'trusts' and 'powers'.

A trust is a mandatory instruction e.g. I give my shares in ABC Ltd to Fred and Lucy (trustees) to hold for the absolute benefit of Mary (beneficiary) subject to her attaining the age of 21 years. Here, the trustees are obliged to give the property to Mary when she becomes 21.

A power is discretionary so, the trustees may use their own judgement as to whether it should be exercised, depending on the circumstances of the beneficiaries. For

example, most trusts contain a power of maintenance, enabling income to be paid to a young beneficiary for keep or the cost of education, even though the beneficiary, Mary, in the example above has no direct right to income until she is 21. There are usually many powers in a well drafted trust, divided between dispositive powers and administrative powers.

Dispositive powers concern the benefits in the underlying trust capital and any income it generates. A power of appointment over income and capital enables the trustees to change the beneficial interests of beneficiaries in the light of future conditions.

The most flexible form of trust is called a discretionary trust: in this variant, no beneficiary has a vested right in income or capital. The trustees may exercise their discretion in the form of a power to appoint income or capital to any one or more of the prospective beneficiaries. If they do not appoint income, it is typically accumulated, that is, saved for future use by the trustees.

Administrative powers give express authorisation to the trustees to undertake the management of the trust in a particular way. In saying this, there is a statutory framework of trusts, currently set out in the Trustee Act 1925, but amended on a number of occasions subsequently, under which trustees could derive authority for various actions. This statutory framework can be narrow in its scope; for instance, it does not allow investment in shares in a family or private company.

There is no civil restriction to a settlor giving wide and sophisticated powers in his or her particular trust. Sometimes trusts partly adopt some of the statutory framework. A wide power of investment enabling the purchase of all possible types of assets is a common express power. A power to 'emigrate' the trust to a different jurisdiction might be an antidote to radical political change in the future. Powers can be placed in the hands of people other than the trustees. An example is that the settlor might reserve the power of dismissing and appointing trustees of the trust to himself or his widow, after his death. In a 'statutory' or normal trust, this power is usually held by the trustees themselves.

Coming onto beneficiaries, if one beneficiary has the vested right from a trust to receive income they are characterised as having an interest in possession. This interest exists even though the trust is not actually generating income because, for example, it holds shares in a family company which is not currently making dividend distributions.

A second example can be looked at: "I give my shares in CDE Ltd to my trustees to pay the income thereof to my wife, Isabel, for her lifetime and thereafter to divide the shares equally and absolutely between our children that survive her".

In this example, Isabel has an 'interest in possession' in the trust; she is often described as being the life tenant. The children are described as reversionary beneficiaries, because their interest in the capital is subject to their mother's prior life

interest. In this example, they are contingent reversionary beneficiaries, because their right to a share in the capital is dependant on surviving their mother. It would be possible as an alternative to ensure that the children of the reversionary beneficiaries took the capital shares that their parent would have taken if they had survived their mother.

BENEFITS OF A TRUST

Trusts have traditionally been used as a tool in succession planning to avoid death duties. Under the current Inheritance Tax “IHT” regime, outright gifts, excluding the settlor and his or her spouse from benefit, usually constitute a potentially exempt transfer “PET” which falls out of liability to Tax in respect of the donor’s estate after 7 years have elapsed.

A private trust is most typically employed in the present era to detach property or assets from a wealthy estate owner so that his or her estate is reduced with the consequence that the extent of Inheritance Tax on eventual death is reduced. The distinct benefits of employing a trust, as opposed to the direct transmission of property to beneficiaries, can be summarised, as follows:

- fiduciary control over assets and voting rights
- benefiting the younger generation without exposing assets to “youthful folly”
- Income Tax benefits for adult children
- Income Tax benefits for infants where the settlor is not a parent
- some measure of protection from creditors and estranged spouses
- Capital Gains Tax benefits

POSSIBLE DISADVANTAGES OF TRUSTS

The key issue for a possible settlor who is concerned with Inheritance Tax mitigation is can he or she afford it? Clients should be sure that they have sufficient assets and pension funding to sustain their lifestyle bearing in mind increasing life expectancy and the financial impact that low interest rates or continuing inflation may have.

Once clients are satisfied with this fundamental issue, trusts can be tax efficient in a number of ways. Whilst different trusts can be created to achieve varying ends, a word of caution is necessary. A trust is usually a new tax payer so far as the Inland Revenue is concerned and may involve the preparation of annual accounts. Managing a trust implies continuing administrative and professional expense so an excessive number is best avoided. A well conceived trust can be flexible in relation

to future contingencies and should be introduced as part of a logical tax planning strategy for the family. If the strategy is clear, one, or at most, two trusts, should be sufficient to achieve most of the new settlor's objectives

EXAMPLES OF TRUSTS

Different types of trusts are illustrated below by reference to the tax benefits that are usually associated with them.

It should be noted that the different trusts described below are not mutually exclusive. In other words, it is feasible and often desirable for one trust to be, in sequence, a discretionary trust, changed to an accumulation and maintenance trust, then an interest in possession trust and finally a "bare trust" by reason of the trustees exercising a given power of appointment over income and capital.

DISCRETIONARY TRUSTS

In this instance, the trustees hold the income and capital for a class of beneficiaries, where no one of them has a vested right to income or capital.

The beneficiaries' collective interests are subject to the trustees 'discretionary' exercise of the power to pay income, or not, to one or more of them. It follows that none of them have an interest in possession in this type of trust.

So far as the settlor is concerned, a discretionary trust gives complete flexibility which is very attractive. An important tax benefit is that no beneficiary is liable to capital taxation in respect of their own death. This liberal feature was much utilised to avoid Estate Duty. On that tax's abolition in 1974, the successor tax, now known as inheritance tax, introduced charges on the capital of a discretionary trust.

If property is given to a discretionary trust, it is an immediately chargeable transfer and if the historical and present total of chargeable transfers made by the settlor exceed £255,000, IHT is chargeable at 20% on the excess. There is a ten yearly charge on capital within a discretionary trust, but the rate of tax does not exceed 6% on these occasions. Finally, there is an 'exit charge' on property leaving a discretionary trust when paid to a beneficiary, or where the discretionary trust is terminated and the trust becomes a different type of trust.

A particular tax benefit of a discretionary trust is that gifts to them, being immediately chargeable transfers for Inheritance Tax purposes, qualify for Hold-over Relief from Capital Gains Tax under Section 260 TCGA, 1992.

Where a donor or settlor wishes to give assets that are contingently liable to Capital Gains Tax, such as shares in a property investment company or quoted equities, and his or her zero rate of cumulative transfers for IHT purposes of £255,000 has not been reduced, a gift of this amount, or less, can be made to a discretionary trust and the chargeable gain 'held-over' to the trustees, thus deferring any cash liability.

Since 1999, where a discretionary trust holds shares in a company and has no carry-forward tax pool, there is an income tax disadvantage where dividends received from the company are distributed to beneficiaries. This disadvantage can be ameliorated by changing the terms of the trust, shortly after its creation, having utilised the holdover facility for CGT purposes.

ACCUMULATION AND MAINTENANCE TRUSTS

These are discretionary or income accumulation trusts set up for infants and beneficiaries under the age of 25 years under which the beneficiaries will become entitled to an interest in the trust capital (either absolutely or as an interest in possession) at an age not exceeding 25. In the interim the income must be accumulated save that applied for the education maintenance and benefit of the beneficiary.

Provided the trust satisfies the IHT exemption requirement, it will enjoy the benefit of exemption from the IHT charging regime for discretionary trusts described above. This means that, until a possible beneficiary acquires a vested interest, the trust capital is free of IHT except in relation to the PET exposure that exists for seven years after the settlor has made a gift to the trust.

INTEREST IN POSSESSION TRUSTS

As stated earlier, if a trust gives a life interest then the life tenant has an interest in possession in the trust and this status characterises the trust. Broadly, an interest in possession subsists where a beneficiary has the right to call for the income arising on the trust assets, i.e. a present right to present enjoyment. Even if no income actually arises, an interest in possession subsists where the beneficiary has the right to enjoy trust capital e.g. occupy a trust residence as his home, or use trust chattels, or would be entitled to income were the non-income producing trust property re-invested to produce income.

A gift to an interest in possession trust is a PET for Inheritance Tax so that, again, if the settlor survives any gift to the trust by seven years, there is no IHT by reference to his or her estate.

However, the Trust is liable to IHT on the death of the person with an interest in possession. If there is a termination of that interest, e.g. by advancing capital to reversionary beneficiaries, there is a PET exposure for 7 years after the termination.

The reason that clients use trusts such as these is to ensure that the benefit of their assets will go to predetermined beneficiaries. For example, a trust will often provide an interest in possession for one's spouse, giving him or her an income interest throughout their lifetime. On the death of the life tenant, the capital will go equally to the settlor's children; perhaps employing an intervening accumulation and maintenance trust if a child is under the age of 25 at the death of the life tenant. This

contrasts with a direct gift of capital to a spouse who may be a spendthrift, or, who, in the fullness of time, may give this received property to charities, or persons other than their children if, for example, he or she remarries.

As a broad proposition, any of the above trusts can be introduced as a component of one's Will, to ensure predetermination of one's assets, if not necessarily any IHT saving.

BARE TRUSTS

This is the simplest form of trust, in which a trustee holds property absolutely for a beneficiary. Bare trusts are often employed to hold property for infants. However any income that arises to any infant under 18 years of age is assessable to Income Tax on the parent, if he or she provided the capital of the trust.

For Capital Gains Tax purposes, S60 TCGA 92 looks through nomineehip or bare trusts where the beneficiary, including any infant, is or would be absolutely entitled as against the trustee so that the acts of the trustee are regarded, in Capital Gains Tax terms, as the act of the beneficiary. Where a 40% taxpayer is contemplating a company sale, it is therefore useful to consider creating bare trusts for relatives and children so that each absolute beneficiary is entitled to the annual exemption of £7,700 and, beyond, the marginal rates of tax of 10% and 20% can be secured. Such transfers must be susceptible to S165 or S260 TCGA 1992 elections between donor and donee, i.e. hold-over relief.

CONCLUSION

This Memorandum has been conceived to give an introduction only to tax planning with trusts. The taxation of trusts is a complicated field with many anti-avoidance features and issues that have not been addressed in this Memorandum. It is important for us to guide you through these when contemplating the creation of a trust.

Finally, the drafting of trusts and advice thereon is a complicated subject. Indeed, most proficient Chancery practitioners or trust draughtsmen spend their entire careers in this speciality. As taxation advisers, we recommend that you use the services of an appropriate specialist and, in particular, be circumspect about the use of pro forma trust documentation which is issued by some life offices.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to merely alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.