Trusts: A detailed guide

Trusts can be useful tools in a variety of situations. If you have explored different ways of providing for the future of your loved ones, you will have undoubtedly come across trusts. A trust may be able to save you tax or allow you to pass your assets on to friends and family in the most effective way possible.

Whilst trusts are surprisingly common, and have many advantages, they can also be confusing. You might have wondered whether setting up a trust could help you, only to be put off by the different trusts available, and the bewildering array of terms used to describe them. This factsheet aims to cut through some of this mystery, give you a good idea of whether a trust may be useful to you, and, if so, help determine which kind of trust would best accomplish your intentions.

What is a trust?

A trust is a really a legal concept. It is a mechanism by which money, property and possessions (collectively referred to throughout this factsheet as 'assets') can be held in a different way from the 'standard' form of ownership – i.e. owning something outright. This is explored a bit further in the boxout below: '*The theory behind trusts*'.

The most basic example of a trust involves transferring assets to trustees, who will then hold the assets on behalf of one or more beneficiaries. Both the trustees and the beneficiaries will have some ownership rights over the assets, although these rights are very different from each other.

Who is involved in a trust?

The parties to a trust are referred to using specific terms. These are set out here:

- ***Settlor*** – the creator of a trust is often called the settlor. They are the original owner of the assets being 'settled' (put) into the trust.

- *Trustee* – a trustee is responsible for holding and managing the trust assets. They have authority to deal with the trust assets in certain ways, but they are under a strict duty to act in the best interests of the beneficiaries. They may also have other powers and duties depending on the terms of the trust. Theoretically, trustees hold 'legal ownership' over the trust assets – see the boxout below: '*The theory behind trusts*'.

- *Beneficiary* – a beneficiary is someone who can, or will, benefit from the trust. This may take different forms and the rights a beneficiary has over the trust assets will vary depending on the trust. When a trust ends, it will be the beneficiaries who will receive the trust assets. Theoretically, beneficiaries hold some form of 'equitable ownership' over the trust assets – again, see the boxout below: '*The theory behind trusts*'.

Someone may fulfil more than one of these roles in a trust; a trustee may also be a beneficiary, for example.

The theory behind trusts

Here's where things get a bit technical! You don't necessarily need to know any of the theory behind trusts, but it may help you to understand them a bit better.

A key part is to understand how the law treats ownership. Legal theory considers ownership as having two different strands: legal ownership and equitable ownership. When you own an asset outright, there is very little point considering these two strands, but you actually have both legal and equitable ownership of that asset.

Trusts, however, involve splitting the two strands of ownership. One person might be given legal ownership of an asset and another given equitable ownership. This makes it possible for more than one person to have rights in a piece of property, and for those rights to be controlled by the terms of the trust.

So what is the difference between these two strands?

Legal ownership
Generally, legal ownership covers the rights for dealing with assets on a day to day basis. For example, legal ownership of a bank account would give you power to transfer money from the account, whereas, over a house, it could mean the power to sell it. However, legal ownership does not give any rights to personally gain or benefit from the asset.

Equitable ownership
The rights under equitable ownership vary based on the terms of the trust (whether

one has been set up expressly or a trust has arisen automatically through circumstance). However, in broad terms, think of equitable ownership as the rights to benefit from, or enjoy, the trust assets in some way. So, if the legal owner of a house sold it, but someone else was the equitable owner, the legal owner would have to keep the proceeds from the sale intact for the equitable owner.

As an aside, any shared ownership of houses and land will involve some kind of trust arrangement, whether it is explicitly stated or not. For example, if you own your home jointly with your partner, a trust is implied. You hold the property as legal and equitable owners – as trustees for yourselves and for each other. The precise nature of this will depend on whether you hold the property as 'joint tenants' or 'tenants-in-common'. Have a look at our separate factsheet on 'Jointly Owned Property' for more information.

General considerations when creating a trust

Before looking at specific kinds of trust, there are some matters which are relevant to any kind of trust. Some of the most important ones are explored here.

Trustees

The trustee role is critical to the operation of a well-managed and dispute-free trust. This means that you must select your trustees carefully when creating a trust. It is possible to appoint professional trustees. Whilst this will incur fees, it can be useful if you think administering the trust may be complicated, or you are concerned your wishes may not be followed otherwise.

It is possible to appoint only one trustee, but it is much more common for there to be more than one. This ensures that, if a trustee is ever unable to perform their duties (for whatever reason), there are others who can take over.

Taxes

Tax is a key consideration in relation to trusts. We will look at each of these taxes in greater depth later in the factsheet, in relation to the different kinds of trust. However, here is a general overview of the main taxes:

- **Inheritance tax** – This is usually assessed on the value of your estate at the time of your death. However, it can also be charged on transfers you make in life which have the effect of reducing the value of your estate. For more information on how inheritance tax works, have a look at our separate factsheet on 'Reducing your Inheritance Tax'.

- **Capital gains tax –** This is charged in certain situations where an asset you own has increased in value. For example, if you bought shares in a company and later sold them for an increased amount, you may be charged capital gains tax on that 'profit'. It is assessed when an asset is 'disposed of'. This might be an actual disposal (where you sell an asset to someone else or give it away as a gift) or a 'deemed' disposal (where the asset may not have strictly changed hands, but still triggers an assessment for capital gains tax). More general information on capital gains tax can be found on the government's website.

- **Income tax** – This can be applied to many different sources of income. In relation to trusts, where trust assets generate an income (such as rent or interest), this will normally be included in the taxable income of the beneficiary who receives it. More general information on income tax can be found on the government's website.

Settlor-interested trusts

As noted above, someone involved in a trust may actually fulfil multiple roles; a trustee may also be a beneficiary of the trust, for example.

If you create a trust and continue to hold some rights over any of the trust assets – either as a beneficiary of the trust or through trust terms which allow the possibility of assets coming back to you – the trust may be classed as 'settlor-interested'. This can lead to situations where you are still treated as owning the trust assets for the purposes of income tax, capital gains tax, and/or inheritance tax.

In most cases, you will want to avoid this as it risks 'undoing' the tax benefits you may hope to achieve through creating the trust.

Registering a trust

Some trusts now have to be registered with HMRC. Often these will be the more complicated kinds of trust. One of the key determining factors will be whether the trustees have incurred, or have potential to incur, a tax liability in a given tax year, for one or more of the specified UK taxes (called 'relevant taxes').

These are:

- Capital Gains Tax
- Income Tax
- Inheritance Tax
- Stamp Duty Land Tax
- Stamp Duty Reserve Tax or Stamp Duty

More information on which trusts you will need to register can be found in our separate factsheet 'Trust & Estate Registration'.

Bare trusts

Bare trusts could be considered the classic form of a trust and they are often the most straightforward. They involve the settlor giving assets to the trustees to hold on behalf of a single beneficiary – without any complicated trust terms to alter the beneficiary's rights.

The key feature of a bare trust is that the beneficiary is considered to be absolutely entitled to the trust assets. This means all that the trustees can do is use their rights to look after the assets for that beneficiary.

Possible uses for a bare trust

In essence, bare trusts are useful for appointing a 'nominee' to hold assets for you or someone else. A bare trust can resolve situations where you want to give assets to someone but they are legally incapable of owning them outright.

One example would be a child under the age of 18. No-one under 18 can legally own a house or land, but if you wanted to make sure they received such a property, you could create a bare trust in which they were the beneficiary. The trustees would then be able to hold the property for them until they were 18, at which point the property could be transferred out of the trust to the beneficiary.

How are bare trusts taxed?

Inheritance tax – There are two different points where inheritance tax may be charged in relation to a bare trust:

1. When you set up the trust, the transfer of assets will be classed as a 'potentially exempt transfer' (see the boxout below), as long as you are not the beneficiary of the trust.

2. Because the beneficiary of a bare trust is absolutely entitled to the income and capital of trust assets, any assets which are still in a bare trust at the time of *the beneficiary's* death is treated as part of their estate. This means that the value of the trust assets will be included in their inheritance tax calculation. You will only have the trust assets considered as part of your estate upon death if point 1 applies, or if you are the beneficiary of the trust.

Potentially exempt transfers

Inheritance tax is usually assessed on the value of your estate at the time of your death. Potentially exempt transfers, however, are a way in which lifetime transfers (such as gifts or transfers of assets into a trust) can also be assessed for inheritance tax.

If you die within 7 years of making a potentially exempt transfer, some or all of its value may be included in the inheritance tax assessment of your estate. Outliving the transfer by 7 years or more, however, means the transferred assets may not be included in the assessment. Thus, the transfer is 'potentially exempt' from tax.

Our separate factsheet on ['Reducing your Inheritance Tax'] provides further detail on potentially exempt transfers.

Income tax – Any income generated by the bare trust assets will be considered part of the beneficiary's taxable income. The trustees can arrange payment on the beneficiary's behalf but it will be the beneficiary who is liable for the tax.

Capital gains tax – Similarly, any chargeable gains realised on trust assets will fall on the beneficiary, meaning they will be responsible for any capital gains tax payable. It is important to note, however, that assets transferred out of the trust to the beneficiary will not attract capital gains tax. This is because the beneficiary is already fully entitled to the trust assets so taking any of them out of the trust arrangement is not actually a 'gain'.

You, as the settlor, may also incur a capital gains tax charge when transferring an asset into a trust. It is treated as a deemed disposal, with the trustees acquiring the asset at the current market value. So, if this value is higher than that for which you acquired the asset, you may have to pay capital gains tax.

Bare trusts summary

- Often the simplest form of trust arrangement.
- Can be used to hold an asset for someone who is not yet able to own it themselves.
- The tax burden will fall on the beneficiary of the bare trust in most situations.
- You could incur inheritance tax and/or capital gains tax liabilities when transferring assets into a bare trust.

Life interest trusts (or 'interest in possession' trusts)

Life interest trusts allow you to provide someone with an interest in trust assets which will only last for their lifetime. This has many implications, but crucially it means the person given that interest will not be able to decide who inherits the assets from them. Instead, the assets will pass according to the terms of the trust you have created.

When you set up a life interest trust, you will specify who will receive the life interest. That person is referred to as the 'life tenant'. You will also indicate one or more beneficiaries who will become absolutely entitled to the trust assets after the life tenant's death.

The life tenant's interest may entitle them to income generated by trust assets, or it may allow them the *use* of the assets (for example, if a house is contained in the trust they might be granted the right to live in that house). However, as mentioned above, the life tenant will have no control over where the trust assets will pass after their death.

> *Possible uses for a life interest trust*
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> A life interest trust is a good way of retaining control over who ultimately inherits certain assets from you.
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> A common situation in which this may be useful is where you live with your partner in a house which belongs to you, and you both have children from previous relationships. You may want to ensure that your children receive your house, but also want your partner to be able to live in the house after you are gone. A life interest trust, naming your partner as the life tenant and your children as beneficiaries, would be able to guarantee this. Your partner will be entitled to live there for the rest of their lifetime but would be unable to then transfer the house to their own children, either in life or upon their death. Your children would become absolutely entitled to the house when your partner died.

You can also draft alternative terms for a life interest trust to allow for greater flexibility. For example, you might include a term which allows your trustees the power to end the life interest prematurely. This could be helpful to the beneficiaries and/or the life tenant. For example, if the life tenant and beneficiaries are in need of capital, the trustees could end a life interest over a house in order to sell it and distribute the proceeds.

How are life interest trusts taxed?

Inheritance tax – If you set up a life interest trust during your lifetime, you may incur an immediate charge to inheritance tax. This will occur if the value of the trust assets is greater than your inheritance tax 'nil rate band'. Currently the nil rate band is £325,000. In contrast to a potentially exempt transfer (see boxout above), the charge is incurred straight away and there is no possibility of this being exempted by outliving the transfer. The tax rate for lifetime transfers is lower than the standard rate of inheritance tax upon death, however (20% rather than the 40% rate charged on death).

Once a life interest trust has been set up, it will usually be taxed under a tax scheme called the 'relevant property regime' (see the boxout below).

There are some exceptions where the relevant property regime will not apply, however. Before 22 March 2006, all of the assets in a life interest trust were treated as belonging to the life tenant for inheritance tax purposes. As such, upon the life tenant's death, the trust assets would be included in their estate when assessing the inheritance tax.

For life interest trusts created on or after 22 March 2006, this will only happen in situations where there is an 'immediate post-death interest' or in certain special circumstances, such as where a disabled person's interest is created, for example.

An immediate post-death interest is generally where the life tenant gains their life interest upon the settlor's death, i.e. through a life interest trust set up in the settlor's Will or, in rarer situations, through intestacy.

The relevant property regime

This is a scheme of charging inheritance tax on certain trust arrangements, it is not exclusive to life interest trusts.

The relevant property regime has many provisions but, in general, it involves inheritance tax being charged every 10 years that a trust is running, starting with the 10-year anniversary of the trust's creation or, for Will trusts, from the date of death.

There are also inheritance tax charges made when assets leave the trust (with some limited exceptions) or when assets are no longer in the form of 'relevant property'. These are called 'exit charges' and are based on the reduction of value to the trust. They are charged in proportion to how far through the current 10-year period the transfer occurs.

Charges under the relevant property regime will fall on the trustees to pay from trust funds.

Assets which are already in a trust falling under the relevant property regime at the time of your death will *not* be included in your estate for inheritance tax purposes.

Capital gains tax – When beneficiaries become absolutely entitled to trust assets, for example on the death of the life tenant, this is treated as a deemed disposal for the purposes of capital gains tax. This means that the market value of any assets will need to be assessed and, if any gains have been realised on them, the trustees may have to pay capital gains tax in relation to the gained value.

You, as the settlor, may also incur a capital gains tax charge when transferring an asset into a trust. It is treated as a deemed disposal, with the trustees acquiring the asset at the current market value. So, if this value is higher than that at which you acquired the asset, you may have to pay capital gains tax.

Income tax – The life tenant's rights to enjoy the income from trust assets mean that the income they receive will be added to their own personal income. As such, they will have to pay any income tax due on this trust income.

Life interest trusts summary

- Allow you to ensure the capital value of an asset is passed on to the beneficiaries of your choice, whilst also allowing someone else to enjoy the income or use of the asset during their lifetime.
- Can be used to create more flexible arrangements where trustees are given powers to override the life interest.
- The inheritance tax burden may fall upon the life tenant or the trust itself. The provisions to determine this are complicated.
- You may incur inheritance tax and/or capital gains tax liabilities when transferring assets into a life interest trust.

Discretionary trusts

Discretionary trusts are characterised by the trustees having the power to choose how, or whether, to distribute trust assets or income to the beneficiaries. It means trustees may decide how much each beneficiary may receive, and can even decide not to give anything to some beneficiaries.

In contrast to most other trusts, the beneficiaries have no right to the income or assets from the trust until the trustee decides they do.

If you set up a discretionary trust, you can refer to certain named beneficiaries or you may specify a 'class' of beneficiaries. For example, your discretionary trust may state that it is for the benefit of 'all of my grandchildren who attain the age of 21'. This would mean that, although not specifically named, any of your grandchildren who are 21 or over would be within the class of beneficiaries, and eligible to receive trust assets or income if the trustees so decided.

Possible uses for a discretionary trust

You can use a discretionary trust as a way to provide for beneficiaries whom, for whatever reason, you do not yet wish to receive the assets. Reasons for this could be that:

- A beneficiary might be declared bankrupt
- A beneficiary is going through a divorce
- There are young beneficiaries

Whereas in a bare trust, the beneficiary is treated as owning the trust property in many situations, a discretionary trust gives no such entitlement. It means that, if a bare trust were used for a beneficiary going through divorce proceedings, for example, the beneficiary would be treated as owning the trust assets and so those assets could be included as part of any divorce settlement. This may not be the case if they were the beneficiary of a discretionary trust.

When making long-term plans, it can be difficult to predict which of your potential beneficiaries might be in greatest need. A discretionary trust can be made flexible enough to allow your trustees to react to events as they arise.

Discretionary trusts may also allow you to provide for beneficiaries whom you may never meet, such as great-grandchildren or perhaps even more distant descendants. As long as the class of beneficiaries specified in the trust covers them, a discretionary trust could benefit someone born long after the trust was created.

There are some disadvantages to discretionary trusts, however. Due to their more complex nature, the administration costs for the trust may be higher than more straightforward arrangements, although there are ways to mitigate this.

Discretionary trusts also place a lot of power into the hands of your trustees. You must select your trustees very carefully as a result and you may wish to provide them with additional guidance as to how you wish them to administer the trust by creating, for example, a letter of wishes to sit alongside the trust.

As mentioned above, it is entirely possible for a beneficiary to receive nothing from the trust if the trustees decide this is the right way to distribute the income or assets. This may lead to jealousy amongst potential beneficiaries, perhaps causing acrimony and legal disputes.

How are discretionary trusts taxed?

Inheritance tax – The inheritance tax treatment of discretionary trusts is quite complicated. It will depend on a few different circumstances – the first of these is whether the discretionary trust was set up in your lifetime or whether it is to come into being through your Will (referred to as a Will trust).

Lifetime discretionary trusts

In a similar way to a life interest trust, transfers into discretionary trusts during your lifetime can incur immediate inheritance tax charges. Again, this will occur if the value of the trust assets is greater than your inheritance tax 'nil rate band', which is currently £325,000. The tax rate for lifetime transfers is lower than the standard rate of inheritance tax upon death, however (20% rather than the 40% rate charged on death).

Once set up, the trust will be subject to inheritance tax under the 'relevant property regime' (see the boxout above).

Discretionary Will trusts

If your Will provides for the creation of a discretionary trust, the relevant property regime may not apply. Special provisions mean that a discretionary trust which is completely distributed within 2 years of the date of your death is taxed differently. Instead, in most situations, the trust property will be taken into account in your estate's inheritance tax calculation, as though the trust assets were still a part of your estate. These provisions can be used to 'dismantle' the trust by trustees if this would be advantageous. This also adds a further degree of flexibility to the discretionary trust and can potentially avoid inheritance tax if your estate is able to make use of exemptions or reliefs which would not be open to the trust under the relevant property regime.

Income tax – Any income generated by the trust assets will be payable by the trustees out of the trust funds. If the income is then advanced to one or more of the beneficiaries, it means some income tax will already have been paid on it. The trust's income tax rate may well differ from that paid by a beneficiary:

- If the beneficiary pays income tax at a higher rate, the tax already paid will be taken into account but the beneficiary will have to pay the difference.
- If the beneficiary would have paid less income tax than that paid by the trustees, the beneficiary can claim a repayment.

Capital gains tax – Any disposals, or deemed disposals, of the assets in the trust may incur charges to capital gains tax. If any such tax is payable, it will be the trustees who are responsible. Actual disposals will include situations where, for example, the trustees sell a property contained within the trust. The proceeds of the sale will still be held on trust but if there has been a gain on the value of that property (compared to its value at the time it was acquired by, or put into, the trust), this would result in a capital gains tax charge.

Deemed disposals include situations where a beneficiary becomes absolutely entitled to any trust assets. Usually this will be when trustees use their discretion to advance trust assets to that beneficiary. For capital gains tax, this is treated as if the beneficiary were buying the asset at the current market value, so a taxable gain for the trust could occur. Again, it would be the trustees who would be responsible for paying this out of the trust funds.

Once the asset is transferred to the beneficiary, if they later go on to sell it, they may face a capital gains tax charge themselves.

Also, you, as the settlor, may incur a capital gains tax charge when transferring an asset into a trust. It is treated as a deemed disposal, with the trustees acquiring the asset at the current market value. So, if this value is higher than that for which you acquired it, this may be a taxable gain.

Discretionary trust summary

- Flexible.
- Greater power for trustees – which may provide both added risks and extra benefits.
- Some beneficiaries may not receive any trust assets or income if the trustees so decide.
- Potential for disputes to arise between beneficiaries.
- Tax burden will fall mainly on the trustees, which may deplete the trust assets.
- You may incur inheritance tax and/or capital gains tax liabilities when transferring assets into a discretionary trust.

Personal injury trusts

Rather than being a distinct kind of trust, personal injury trusts provide a special way of holding compensation you may receive from a personal injury claim. Any of the trusts detailed in this factsheet could be used as a personal injury trust, provided the special requirements of a personal injury trust are met.

Personal injury trusts bring several financial advantages, particularly in preserving any means-tested benefits which the injured person may have been receiving.

For much more detail on personal injury trusts, have a look at our separate 'Personal Injury Trusts' factsheet.

How Roche Legal can help

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