



The Finance Act 2006 (FA 2006) introduced some significant changes to the inheritance tax regime for trusts and in so doing focused attention again on the use of trusts as vehicles for estate planning and asset protection. This briefing provides some background on what a trust is, how and why it may be used and outlines the tax issues which relate to trusts. It is always important to obtain professional advice in this area.

## A matter of trust

### What is a trust?

Trusts are by no means modern arrangements. Their origins can be traced back to the time of the Normans when the barons set up legal arrangements to protect their assets, alongside the more tangible castles which had a similar practical purpose.

A trust is essentially a legal arrangement that allows the ownership of an asset to be separated from the right to benefit from that asset. The legal owners of the asset are the 'trustees'; those with the right to benefit are called the 'beneficiaries'. The document which sets out the arrangement is the 'trust deed' and it is that document that forms the basis of the whole arrangement. Trusts are governed by what are known as the rules of equity, which is a specific branch of law, and arguments about trusts will ultimately be matters for the courts to decide.

A trust is a separate legal entity and for tax purposes exists as a taxable person. In English law a trust can have a life of up to 80 years. The person who sets up the trust is referred to as the 'settlor'. It is always important to be clear who this person is because, as will become clear later, there are some UK tax consequences which can follow.

### Trustees

The human face of the trust are the trustees and it is they who have the ultimate responsibility for what the trust does. The role of trustees is therefore critical and the choice of trustees is very important. Those accepting the role of trustee must understand the responsibilities that go with the job. The trustees have the task of managing the trust assets, deciding how the trust income will be earned and how the capital and income will be dealt with in accordance with the trust deed.

### Beneficiaries

The identification of the beneficiaries is obviously very important. They can be specifically identified by name or by class eg 'all my children'. Given that a trust can potentially last a long time it is usual to include the possibility of future

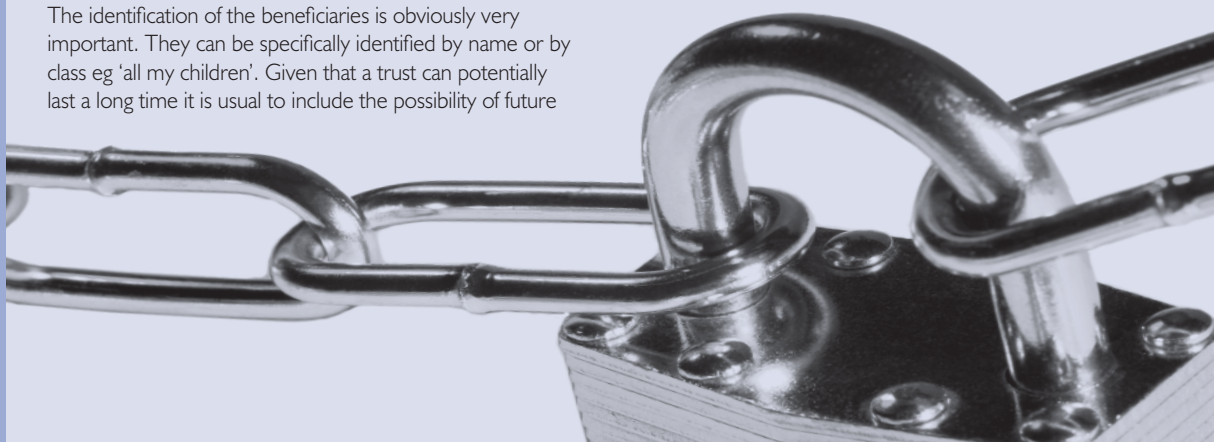
generations becoming beneficiaries. It is also common practice to allow new beneficiaries to be added by the trustees although this usually involves having the consent of the settlor in their lifetime.

Beneficiaries will have interests in either the capital or the income of the trust or, in some cases, interests in both. The trust deed needs to spell out those interests so that there can be no room for doubt. In some cases the trust deed will state that a beneficiary has a right to receive the trust income. This is referred to as an 'interest in possession' (sometimes called a 'life interest'). Where this is in place the trustees have no choice in what they do with the income each year. In other cases the decision as to what to do with the income may be left to the trustees' discretion. They may choose to pay out some or all of the income to beneficiaries and may also have complete discretion as to which beneficiaries should receive anything. They could also decide to simply accumulate the income.

The right of the beneficiaries to receive the capital from the trust will also be set out in the deed. The right may arise when the beneficiary reaches a specific age or it may be that it is left at the discretion of the trustees. There will usually be a power to enable the trustees to advance capital at any time if they decide that this is the right thing to do. When a beneficiary receives capital, it is said that they become 'absolutely entitled' to the assets and this has specific tax consequences.

### Types of trust

The specific powers in the trust deed give rise to the two basic types of trust which are used. A trust where the beneficiary has the right to receive the income directly is referred to as an 'interest in possession' or 'life interest' trust. Where the trustees have the right to take the decisions, the trust will be referred to as a 'discretionary trust'.



## Setting up a trust

The process of setting up a trust in lifetime need not be complicated. A solicitor can draft a deed although it is important that each deed should be specifically tailored for the particular family. It needs to reflect all the things that the settlor would want to do with the trust. The initial capital going into the trust can be small - £10 will be sufficient - although the real benefits will come from moving other assets into the trust. The key issues to consider are:

- Who should act as trustees?
- What assets should go into the trust?
- Who will be the beneficiaries?
- What are the rights to income and capital?
- When should the beneficiaries receive those rights?

A trust can also be created through a Will as a means of devolving some or all of the estate of the deceased. The same issues as outlined above will need to be considered and the trust will be incorporated directly into the wording of the Will.

## Tax issues

It is true to say that HMRC have always had a somewhat wary view of trusts. They recognise the existence of trusts as separate legal entities for tax purposes but they seem to be inherently suspicious that trusts are usually

employed as vehicles for tax avoidance, a view that seemed to drive the FA 2006 changes.

The possibility of using trusts to mitigate income tax and capital gains tax (CGT) liabilities is recognised by a raft of anti-avoidance provisions for these taxes. The effect of these provisions is to look to see if the settlor, their spouse and in some cases their dependants, can benefit from the trust and, if that is the case, the tax charge on income and gains received by the trust will fall on the settlor directly. These rules are complex but must always be considered as part of the process of creating the trust. Clearly professional advice should be sought.

## Inheritance tax (IHT) rules post 22 March 2006

The role of trusts as vehicles for estate planning has changed significantly as a result of FA 2006. Discretionary and interest in possession trusts that were established before 22 March 2006 will not generally be affected by the new rules. Special types of trust for children known as 'accumulation and maintenance trusts' are potentially affected. Where these trusts are in existence advice needs to be taken as a matter of urgency and certainly before 6 April 2008 when the tax rules for these trusts change.

In general terms the IHT legislation will impose charges to tax on a trust created in the settlor's lifetime after 22 March 2006 at three stages:

- on the creation of the trust;
- during the lifetime of the trust by a charge every ten years; and
- when the assets leave the trust.

It is important to note that, looked at from the beneficiary's point of view, the value of their interest in a trust created after 22 March 2006 will not generally form part of their estate for IHT purposes. This is a significant change because, prior to 22 March 2006, where a beneficiary held an interest in possession in a settlement, the value of the trust assets would form part of their estate for IHT purposes.

### Example

X created a trust for the benefit of Y in 2002. Y has an interest in possession in the trust and the value of the assets in the trust is £2m. Y dies in 2007 and their estate will be effectively increased for IHT purposes by the £2m value of the trust assets.

If the trust had been created after 22 March 2006, there would be no IHT charge on the death of Y.

There may now be long term IHT savings in holding assets in trusts, notwithstanding the various IHT charges mentioned above.

## Why use a trust?

There are four basic reasons why the use of a trust can be an important part of asset planning for an individual.

### Control

The role of the trustee is critical to the whole process and in an individual's lifetime they may choose to give assets to a trust but can retain effective control of them by acting as a trustee. This could be important where the assets are shares in the family company and those shares carry voting rights which could control the company.

### Example

Dad currently owns 90% of the shares in the family company. He wants to transfer some of the shares but, because he is not sure about the ability of his children to take decisions regarding the company, he is reluctant to give them the shares directly. He could opt to put the shares into a trust and to act as a trustee himself. He would then exercise the voting rights connected to those shares. He must, however, remember that he must now exercise those rights for the benefit of the children and not for any personal benefit.

### Protection

This is the most common reason for using trusts. There may be concern that the children may fritter away the value of the assets or they may enter into a marriage which breaks up and the divorce courts decide to pass assets to the spouses. Parents may therefore be reluctant to give assets directly to their offspring and a trust can provide a useful alternative. The trust can provide for the income from the assets to be paid out to the children but the capital can stay locked in the trust, although the trustees could have the

power to advance capital if that was needed.

### Flexibility

Although they look cumbersome legal documents, trusts can be very flexible ways of holding family assets. A discretionary trust allows income to be spread around the family without changing the direct ownership of the assets which stay in the trust. The power to advance capital gives flexibility and many trusts also have the power to appoint capital to new trusts so that changes in the family situation down the years can be taken into account.

### Deferral

Many people are happy to accept the idea that giving away assets will help ease the overall IHT burden for their family but they are uncertain as to whom to give the assets. This may be a particular problem when children are young or unsettled in their life. The parent cannot see a

clear line of action and so does nothing. A trust provides a way of securing the tax advantage of getting assets out of an estate without having to take a final decision on the destination of those assets. That decision can be taken by the trustees over the following 80 years.

### Example

Dad has his 90% shareholding in the company and wants to reduce his holding. His eldest son has just completed university and is starting work in the family company. His middle daughter is still at university and the youngest child is still at school. If he puts the assets into trust he will achieve the transfer of value for tax purposes but can leave it to the trustees to decide if and when each child should receive any shares in their own right.

# The following notes summarise all the tax issues arising in the key stages of the life of a trust.

## Creation of a trust

When any trust is created in someone's lifetime, the transfer of assets into the trust will constitute a chargeable transfer for IHT purposes. This means that any value in excess of the available nil rate band (£285,000 for 2006/07 and £300,000 for 2007/08) will be charged to IHT at 20%. So if an individual puts cash of £500,000 into a trust for the benefit of his children in May 2007 the IHT liability will be £40,000.

Where the assets are business assets and qualify for business property relief or agricultural property relief, that relief will reduce the IHT liability in some cases to nil.

One word of warning. If an individual creates a trust of which they are also a beneficiary, any IHT advantage will be negated by the rules on 'gifts with reservation' which will effectively treat the assets as remaining in the settlor's estate.

If the assets transferred into a trust are assets within the scope of CGT, there is deemed to be a disposal of the assets by the settlor at market value. It should be possible to defer that tax charge in most cases until the assets are either sold by the trustees or transferred out to the beneficiaries.

## Lifetime of a trust

If the trust generates income, the rules are different between discretionary and interest in possession trusts. Income of a discretionary trust is firstly taxable on the trustees at a special rate for trusts of 40% (32.5% for dividend income). If the income is paid out to beneficiaries the tax paid by the trustees will usually be offset, as the paid out income is taxed as part of the beneficiaries' income.

Income received by an interest in possession trust will be subject to lower tax rates on the trustees. However, the income is deemed to be received at the same time by the beneficiaries and therefore there may be further tax payable by the beneficiaries if they are higher rate taxpayers.

The trustees will be liable to CGT on any assets they dispose of. They are entitled to an annual exemption which is half that available to an individual (subject to a further reduction depending on how many trusts have been established). Trustees qualify for taper relief, including business asset taper where appropriate.

An IHT charge may arise on each ten-yearly anniversary of the trust. The calculation of the charge is based on the value of the assets in the trust at the ten year anniversary. The basis of the calculation is complex but suffice it to say that currently the rate of tax payable will be 0% to 6%. Given that the assets are not chargeable on the death of a beneficiary there may be an advantage in paying these low rates every ten years.

## Assets leave the trust

Assets may leave a trust because the beneficiaries become absolutely entitled to the assets under the terms of the trust or because the trustees decide to advance the assets to the beneficiaries.

There are no income tax consequences when assets leave the trust other than any continuing income will be taxed directly on the beneficiary.

The trustees will be deemed to make a disposal of the assets at market value and so there may well be a CGT charge. Again it may be possible to claim a deferral of that tax liability.

When assets leave a post 22 March 2006 trust there will be an IHT exit charge. This is based on the value of the assets at that point. The precise calculation depends on whether or not exit takes place before or after the first ten year anniversary. Again the rate of charge will be 0% to 6%. Once assets are in the direct estate of the beneficiary they are potentially liable to IHT at 40%.

## Trusts with special treatment post 22 March 2006

There are three situations in which the pre 2006 rules on interest in possession trusts continue to apply after 22 March 2006. These are:

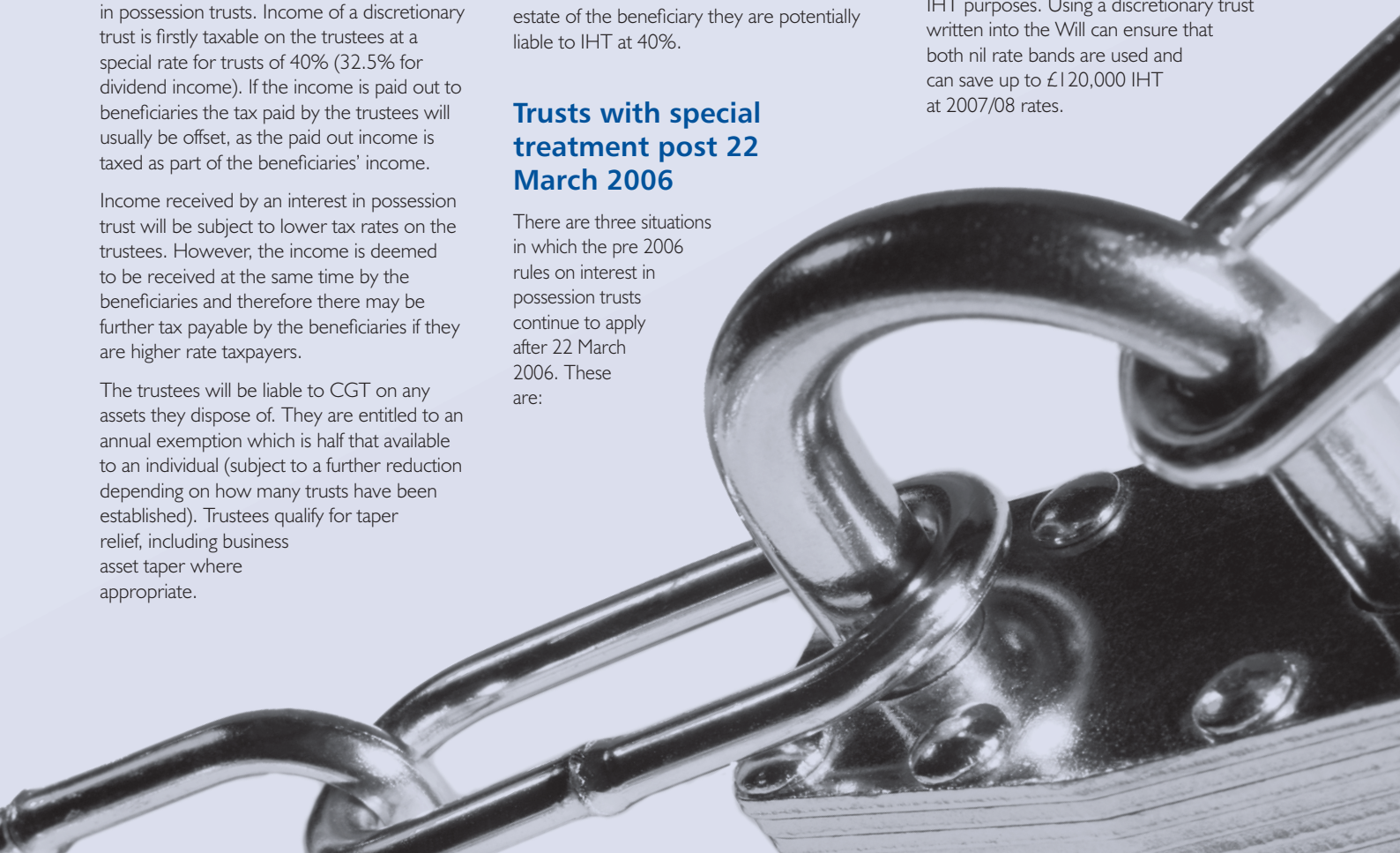
- trusts created under a Will which grant a life interest to a beneficiary immediately on the death of the testator;
- trusts which are established for the benefit of a person with a serious disability;
- trusts which were created before 22 March 2006, had a beneficiary with a life interest at that date and the life tenant is changed before 6 April 2008.

In these three situations, there will be an IHT charge on the value of the trust assets on the death of the beneficiary.

One other type of trust which is given special treatment is known as a 'bereaved minors trust'. This is a trust created on the death of a parent for their children with the clear requirement that the children will hold the assets absolutely when they reach the age of 18 years. These trusts will have a charge on entry but no other IHT charges. A modified and slightly less favourable regime applies where the child will take an absolute interest no later than the age of 25 years.

## Using a trust in a Will

One important use of a discretionary trust can be in Will planning for a married couple. Transfers between spouses (or civil partners) are exempt from IHT. Although this sounds attractive in deferring tax liability until the second death, it can mean in some cases that the couple fail to use one nil rate band for IHT purposes. Using a discretionary trust written into the Will can ensure that both nil rate bands are used and can save up to £120,000 IHT at 2007/08 rates.





### Example

Mr and Mrs W have a joint estate of £500,000 owned equally between them. Mr W dies and his estate passes directly to Mrs W and will be exempt from IHT. When Mrs W dies the whole estate of £600,000 is charged to tax at 40% after a nil rate band of say £300,000. This creates an IHT liability of  $£300,000 \times 40\% = £120,000$ .

If Mr W had created a discretionary trust in his Will to take assets up to the value of the nil rate band, that would have been a chargeable transfer for IHT but at a tax rate of 0%. Mrs W could be a discretionary beneficiary of the trust and so her position in terms of use of the assets would be protected. In this case the transfer into the trust would be £300,000.

When Mrs W dies her own estate will be £300,000 and her discretionary interest in the trust in her late husband's Will is ignored for IHT purposes. Assuming the nil rate band is still £300,000 there will be no charge on her death and overall the couple will have saved £120,000 of IHT which can effectively be enjoyed by their beneficiaries.

## Using offshore trusts

The implicit assumption made so far in this factsheet is that the trusts being referred to are trusts created in and operating under UK law. Trusts do not have to be established in the UK and many jurisdictions, particularly in tax havens such as the Channel Islands, recognise the existence of trusts. Setting up trusts in such locations must involve handing over control of assets to the trustees who will, for tax reasons, need to be outside the UK. For some people this is a step too far.

Not surprisingly HMRC does not like the use of offshore trusts and over the past 15 years has introduced legislation which renders such trusts largely ineffective for individuals who are UK resident, ordinarily resident and domiciled. It is not being emotive to say that a UK domiciled individual creating an offshore trust is almost certainly inviting close HMRC scrutiny of their financial affairs.

If an individual is not domiciled in the UK there may be tax advantages across the range of taxes in using an offshore trust. The issue of domicile is too complex to go into in detail in this briefing and specific advice needs to be taken.

A non domiciled individual can shelter all their non UK assets from the scope of IHT by the use of a trust and can also gain income tax and CGT advantages by limiting the effect of the anti-avoidance legislation. Individuals who are non domiciled in the UK may become domiciled for IHT purposes after 16 years of continuous residence and should take steps to mitigate their exposure to IHT well before that stage is reached.

### To sum up

Trusts can provide an effective way to hold family wealth. They can provide protection for the assets and enable a long term strategy for passing down the family wealth to be evolved and actioned. There are tax issues which need to be taken into account and whilst the post March 2006 IHT regime appears to have some drawbacks, with careful planning long term savings can be made. The tax and legal issues involved in using trusts can be complex and professional advice should be taken in every case.

## Glossary

**Absolutely entitled** - the beneficiary has the full right to both income and capital

**Accumulation** - the practice of keeping income within the trust rather than paying it out to beneficiaries

**Beneficiary** - someone who can benefit from the trust

**Capital** - the funds placed into the trust by the settlor

**Disabled person's interest** - a trust in which funds are held for the benefit of a person who has a disability within the meaning of the IHT legislation

**Discretionary** - applied to a trust where the decisions about income and capital are left to the trustees alone

**Gift with reservation** - a gift of an asset where the donor retains some rights or benefits

**Interest in possession** - the automatic right to receive the income of the trust each year

**Life interest** - see 'interest in possession'

**Life tenant** - the individual who holds the interest in possession

**Nil rate band** - the first part of an individual's estate which is taxed at 0% for IHT (2007/08 £300,000)

**Power of advancement** - the legal power given to trustees to pay out capital to a beneficiary

**Power of appointment** - legal power for trustees of one trust to transfer capital into another trust

**Settlor** - usually the person who has established the trust. NB there is a wider definition for tax purposes

**Trust deed** - the legal document which sets out the terms of the trust and the powers and duties of the trustees

**Trustees** - people with ultimate responsibility for the running of the trust

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