

USE OF TRUSTS

WHAT ARE TRUSTS?

Trusts enable assets to be given away whilst still retaining some control over them. Income can be paid to different persons with the capital ultimately going to other persons.

Trusts, sometimes called settlements, have been part of the legal and tax system for many years and much case law and tax legislation has been formulated over the years. The reasons for using trusts are as valid today as they have always been.

TYPES OF TRUSTS

There are two basic types of trust:

- life interest trust
- discretionary trust.

A discretionary trust with special tax privileges (an accumulation and maintenance trust) can also be established.

Life interest trust

A life interest trust has the following features:

- a nominated beneficiary has an interest in the income from the assets in the trust. This right may be for life or some shorter period (perhaps to a certain age)
- the capital will usually pass onto another beneficiary or beneficiaries.

A typical example is where the widow is left the income for life and on her death the capital passes to the children.

Discretionary trust

A discretionary trust has the following features:

- no beneficiary is entitled to the income as of right
- the settlor gives the trustees discretion to pay the income to one, some or all of the nominated class of possible recipients

- income can be retained by the trustees for up to 21 years
- capital can be gifted to nominated individuals or to a class of beneficiaries.

Accumulation and maintenance trust

An accumulation and maintenance trust is often used by grandparents to benefit their grandchildren.

The normal features are as follows:

- in the early years this operates in a similar manner to the discretionary trust, but usually after an initial period income is given to the beneficiaries as of right, as in the life interest trust
- capital can be paid out when it is hoped that the recipients are more able to control their finances
- capital can be released in earlier years, at the trustees' discretion, if needed to help a beneficiary.

TAX ADVANTAGES

Many people have not realised how useful trusts can be as a tax planning tool.

Giving property away to trustees (ensuring neither the settlor or their spouse has a benefit) determines the settlor's inheritance tax position for that gift.

Gifts to a life interest trust are potentially exempt transfers (PETs) and providing the settlor survives seven years from the date of the gift, no inheritance tax is payable.

Gifts to an accumulation and maintenance trust are also PETs.

There is a potential charge in setting up a discretionary trust but if the gift is below £250,000, no tax will be payable.

If assets are transferred to trustees, this is considered a disposal for capital gains tax purposes but in many situations any capital gain arising can be deferred.

Gains within the trust are charged at 34% (6% less than a higher rate taxpayer).

TAX TREATMENT OF THE TRUSTS

Life interest trusts are taxed on their income at 10% (dividends), 20% (interest) and 22% (other income). Discretionary trusts (including accumulation and maintenance trusts during the 'discretionary' period) pay tax at 25% (dividends) and 34% (other income).

Income paid to life interest beneficiaries will have an appropriate tax credit available with the effect that they will be treated as if they receive the income as the owners of the assets.

If income is released at the trustees' discretion from discretionary trusts, the beneficiaries will receive the income net of 34% tax. They are able to obtain refunds of any overpaid tax and if they pay tax at 40%, they will get credit for the 34% paid.

Inheritance tax may have to be considered during the trust period and each main type of trust is dealt with differently.

- Life interest trusts will have to be valued when the income beneficiary dies. The value of the trust assets is added to the value of the beneficiary's personal assets to determine the rate of tax payable, with the trustees being liable to pay the trust share of the inheritance tax due from the assets held.
- Discretionary trusts are charged every ten years and by careful planning the value can often be maintained under the taxable limit. Where this is not possible or perhaps desirable, then it should be noted that the maximum tax rate is 6% of the value of the assets in the trust every 10 years. There may alternatively be a charge if assets are appointed out of the trust before a 10 year charge is due.
- Accumulation and maintenance trusts do not pay inheritance tax if the funds are released to the nominated beneficiaries.

WHICH TRUST IS RIGHT FOR ME

The problem

To provide for your family's financial needs in a way that permits maximum flexibility during a period of years with a minimum tax burden.

Possible solution

Discretionary trust or possibly an accumulation and maintenance trust.

The problem

To make gifts now but you are undecided how much to give each donee.

Possible solution

Discretionary trust or possibly an accumulation and maintenance trust.

The problem

Making a gift to start your seven year inheritance tax gift clock running, but extra thinking time is needed before deciding who should receive what.

Possible solution

Discretionary trust.

The problem

To make gifts to children or grandchildren in a tax efficient way.

Possible solution

Accumulation and maintenance trust.

The problem

To make a gift of income to a particular individual, but retaining control over what happens to the capital after the death of that individual.

Possible solution

Life interest trust.

HOW WE CAN HELP

This factsheet briefly covers some aspects of trusts. If you are interested in providing for your family we recommend that you talk to us.

We will be more than happy to provide you with additional information and assistance.

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