Dow Schofield Watts
Private Client Tax

Setting up a Trust

Tax Factsheet

A family trust can be provide a great opportunity to protect family assets whilst allowing the transfer of wealth to the younger generation.

WHAT IS A TRUST?

A trust is a legal arrangement whereby an individual puts assets such as property, investments or cash into a separate fund for the benefit of others - this individual is known as the 'Settlor'.

Once a Settlor transfers assets into trust, he no longer owns them. Instead the Settlor selects a few trusted people or advisors, known as the 'Trustees', to look after and manage the trust assets on his behalf.

Frequently, the settlor may appoint himself as a Trustee along with his spouse or another family member. The Trustees are the legal owners of the trust assets and must run the trust efficiently whilst acting in the best interest of those individuals the trust was established to benefit, namely the 'Beneficiaries'.

The beneficiaries are the only people who are entitled to use or enjoy the income and assets of the trust fund and the Settlor will nominate the person or persons who shall be beneficiaries of the trust. This list can be explicit and included specific individuals or it can be more flexible and include a number of classes of beneficiaries for instance the Settlor's children and future grandchildren.

All the details surrounding the formation of the Trust including the names of the Settlor, Trustees and Beneficiaries, will be set out in a formal trust deed. This is a legal document and include the general terms of the trust in addition to the powers of the Trustees and perhaps other conditions that need to be satisfied for individuals to benefit from the trust assets.

TYPES OF TRUSTS

A Trust can take effect during the Settlor's lifetime or shortly after their death. There are various forms of trusts available and the type of trust an individual uses will depend on how they wish to distribute the income and capital from the trust assets. Broadly speaking, the most common trusts are a 'Discretionary' trust and a 'Life Interest' trust:

DISCRETIONARY TRUSTS

A discretionary trust is the most flexible trust format. Under a discretionary trust, the beneficiaries have no legal entitlement to receive income from the trust, any distributions of income and capital are made entirely at the discretion of the Trustees. The trustees have no obligation to make distributions and they have the power to retain and accumulate income if they see fit.

Discretionary trusts are typically set up when a Settlor wishes the assets within the settlement to benefit a wide class of beneficiaries without being too prescriptive as to who those beneficiaries might be. An example might include a grandparent who sets up a trust for their current grandchildren but also wants to allow future grandchildren to benefit.

LIFE INTEREST TRUSTS

A life interest or interest in possession trust differs to a discretionary trust in that the trustees have no power to accumulate income. Under a life interest trust, the trustees must pay out any income generated within the trust to the designated beneficiaries, known as the 'life tenants'.

The life tenants have a legal entitlement to the net income of the trust, this might be for the duration of their life or until a specific age is attained or a certain point in time is reached. Once this milestone is reached, the capital within the trust passes to another set of beneficiaries, termed the 'remaindermen'.

INHERITANCE TAX BENEFITS

The use of trust can have significant inheritance tax benefits and allows a Settlor to transfer wealth out of his estate, thus saving inheritance tax on death.

Once assets have been transferred into a discretionary trust, they are no longer included in the Settlor's estate (assuming he survives seven years from the date of transfer) and as such they are not charged to inheritance tax on his death.

An inheritance tax charge of 20% is payable when assets are transferred into trust, but assuming the Settlor has his nil rate band available and the aggregate asset value transferred falls below this amount, the IHT rate will be 0%. In addition, any capital gain realised on transfer can be held over until such a time that the assets are appointed out of the trust.

A discretionary trust will be subject to periodic ten year IHT charges, with the charge based on the value of the trust assets at the time of the charge. This charge attracts a maximum rate of 6% and is therefore significantly lower than the 40% rate realised on death. Furthermore, assets such as unquoted shares often qualify for business relief and are not therefore chargeable to inheritance tax when a periodic charge occurs.

TAX EFFICIENT AND FLEXIBLE DISTRIBUTIONS

If administered properly, trusts can be a great way of making tax efficient distributions to those individuals a Settlor wishes to benefit. Distributions can be made directly to the beneficiary or might be used to pay costs such as tuition fees or school fees.

With a discretionary trust, any tax paid by the Trustees on its income is recorded and accumulated in a 'tax pool'. When distributions are made to the beneficiaries, they are deemed to have a tax credit attached to them based on the level of tax paid by the Trust i.e. 45%. This rate is often higher than the marginal rates of tax paid by the beneficiaries themselves and HMRC have provisions in place such that the beneficiaries can claim a refund on the difference in tax paid by the trust and that which would have been paid by them personally.

This can be very worthwhile when looking at making distributions to minor children, as they are often able to claim a full repayment of the tax paid by the trust, resulting in a very tax efficient gross distribution.

MAINTAINING CONTROL

It is often the case that parents or grandparents are keen to make gifts to younger family members, but are concerned that an outright gift may be wasted or misused.

Trusts are a great way of maintaining control when intended beneficiaries are still young and may not have the knowledge or experience to manage assets independently. By gifting an asset into trust, the Settlor can maintain an element of control over the property they have given away. If, for instance, they appoint themselves as a Trustee, then they can play an active role in controlling the level of income distributions a beneficiary receives and make management decisions.

ASSET PROTECTION

A well constructed trust can help to protect the Settlor's assets and assist in ensuring that wealth remains within the family on death - it can also add a layer of protection to assets in the event of divorce. Trusts can also help to provide for a husband or wife after death whilst protecting the interest of any children - this can be particularly useful in family situations where there are children from previous marriages.

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